REPORTS

OF THE

UNITED STATES

TAX COURT

January 1, 1985, to June 30, 1985

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ERRATA

80 T.C. at 833 *(Sennett v. Commissioner)*:

In printing, footnote 6 was inadvertently omitted. At the end of line 9, footnote reference 6 was also omitted. Footnote 6 reads as follows:

[6]The parties submitted the case to us fully stipulated, casting the transaction between petitioner and PPP in December 1968 as a "sale." The parties did not brief the applicability of sec. 736 and we, therefore, do not deem it appropriate to discuss whether petitioner sold his interest in PPP to the other partners or whether PPP "liquidated" petitioner's partnership interest. See *Cooney v. Commissioner*, 65 T.C. 101, 109 (1975). PPP and petitioner treated the transaction of December 1968 as a sale of petitioner's partnership interest for a promissory note by PPP. Petitioners reported the sale of the partnership interest in PPP as the sale of a capital asset, which respondent does not dispute. Moreover, the parties failed to stipulate the date that petitioner made the payment of $109,061 to PPP.

83 T.C. at 541 (*Billman v. Commissioner*):

The following two lines, which should have appeared at the top of this page, were omitted in printing:

his memorandum of law are replete with contemptuous and intemperate charges of fraud and deceit. The record contains

JUDGES OF THE UNITED STATES TAX COURT

Chief Judge

SAMUEL B. STERRETT[1]

Judges

WILLIAM M. FAY[2]
HOWARD A. DAWSON, JR.[3]
CHARLES R. SIMPSON
WILLIAM A. GOFFE
RICHARD C. WILBUR
HERBERT L. CHABOT
ARTHUR L. NIMS III
EDNA G. PARKER
MEADE WHITAKER
JULES G. KÖRNER III
PERRY SHIELDS
LAPSLEY W. HAMBLEN, JR.
MARY ANN COHEN
CHARLES E. CLAPP II
STEPHEN J. SWIFT
JULIAN I. JACOBS
JOEL GERBER
LAWRENCE A. WRIGHT

Senior judges recalled to perform judicial duties under the provisions of section 7447 of the Internal Revenue Code of 1954:

ARNOLD RAUM
WILLIAM M. DRENNEN
IRENE F. SCOTT
THEODORE TANNENWALD, JR.
C. MOXLEY FEATHERSTON
DARRELL D. WILES

Special Trial Judges

JOHN J. PAJAK, *Chief Special Trial Judge*[4]

JAMES M. GUSSIS
FRANCIS J. CANTREL
DANIEL J. DINAN
MARVIN F. PETERSON
FRED R. TANSILL
RANDOLPH F. CALDWELL, JR.
LEE M. GALLOWAY
HELEN A. BUCKLEY
PETER J. PANUTHOS
JOAN SEITZ PATE
HU S. VANDERVORT
LEHMAN C. AARONS

CHARLES S. CASAZZA, *Clerk*

PAUL NEJELSKI, *Court Administrator*

[1]Judge Sterrett succeeded Judge Dawson as Chief Judge on June 2, 1985.
[2]Judge Fay retired May 14, recalled May 15, 1985.
[3]Judge Dawson retired as Chief Judge June 1, recalled June 2, 1985.
[4]By Chief Judge Memorandum 1985-22, Special Trial Judge Pajak was appointed Chief Special Trial Judge, effective June 21, 1985.

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REPORTS

OF THE

UNITED STATES TAX COURT

IRA S. FELDMAN AND SUSAN B. FELDMAN, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 14126–82. Filed January 8, 1985.

Petitioner maintained an office in his home that was rented to his employer for his own use. The employer, of which petitioner was a shareholder and director, paid $5,400 designated as rent to petitioner in 1979. Petitioner reported the rental income and deducted his costs of maintaining the leased space, which he calculated as 15 percent of his home. *Held*: The payments, to the extent they are reasonable, constitute rent, and, under sec. 280A(c)(3), I.R.C. 1954, the costs of producing that income may be deducted in accordance with sec. 280A(c)(5). Reasonable rental value and deductible amounts determined.

Ira S. Feldman, pro se.
Marikay Lee-Martinez, for the respondent.

COHEN, *Judge*: Respondent determined a deficiency of $1,280 in petitioners' 1979 Federal income taxes. The questions for decision are whether petitioners may deduct the costs of maintaining space in their home that is leased to petitioner Ira Feldman's employer for Ira Feldman's use as a home office, and, if so, what amounts are deductible.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Petitioners are husband and wife and resided in Phoenix, Arizona, during the year in issue and when they filed their petition herein. They filed a timely return for 1979 with the Internal Revenue Service in Ogden, Utah. Subsequent references to "petitioner" shall be to Ira S. Feldman.

Prior to and during the year in issue, petitioner was an employee, shareholder, and director of the public accounting firm of Toback, Rubenstein, Feldman, Murray & Freeman (hereinafter referred to as TRFMF or the company). He was in charge of the tax department in 1978 and through August 1979, when he succeeded Harold Toback as managing director of TRFMF. He owned 18.9 percent of the total outstanding shares of stock of the company in 1979.

As a director of the company, petitioner had substantial administrative duties in addition to his client responsibilities and spent many hours beyond the normal workday attending to all of his tasks. Petitioner's office at the company headquarters was open to the rest of the staff, and petitioner was usually available for informal conferences with the other employees. As a result, petitioner rarely had extended periods of uninterrupted work time and found it very difficult to discuss confidential firm business with the other directors while in the office. Petitioner was therefore required to and expected to do a substantial amount of work at home in order to fulfill his high level of responsibility.

In 1977, petitioners contracted for a custom-built nine-room house, of approximately 3,700 square feet of living space, and an adjacent two-car garage. The house was located approximately 4 miles from the company's offices. On the second floor, across from the master bedroom suite, petitioners built a room of approximately 210 square feet of usable space that was designed to serve as an office.

In 1978, Toback and petitioner agreed that the company should lease additional office space for petitioner and that it would be most convenient for both parties if the office were in petitioner's home. Petitioner and TRFMF entered a rental agreement drafted by petitioner for the use of the space in

petitioner's home that petitioner had built for that purpose. The company agreed to pay $450 per month to petitioner as rent for furnished office space and covered space in petitioner's garage for petitioner's car, which was often devoted to business use. They did not consult any expert on market value of rental space; they made their own determination of what they considered fair rental. Petitioner, as lessor, agreed to pay all maintenance and utilities charges. The rental was on a month-to-month basis and was cancelable at the option of the company.

This agreement continued in effect throughout 1979, and, in that year, the company paid petitioner $5,400 designated as rent. In 1979, the fair market value in Phoenix of comparable furnished, high-quality office space that was completely maintained by the lessor and air conditioned 24 hours a day, if needed, was approximately $240 per month ($2,880 per year). The fair rental value of the covered parking space was approximately $20 per month ($240 per year).

Petitioner used the home office on a regular basis exclusively on company business during 1979. On rare occasions he met there with clients because it was more convenient for the client to come to his home than to company headquarters. More frequently, he met there with other company directors to discuss firm business. Petitioner parked his car in the garage space leased by the company.

In the April 1979 issue of the company's client newsletter, petitioner reported to his clients that the Internal Revenue Service was seeking to prepare a "test case" concerning the deductibility of expenses incurred by an employee renting home office space to his employer for the employee's own use. Petitioner outlined the Service's purported criteria for deductibility and suggested ways in which, in his opinion, taxpayers could meet these standards.

On his return for 1979, petitioner reported $5,400 as rental income and claimed deductions of $2,975 as attributable to the production of that income. To calculate his deductions, petitioner first determined that 15 percent of his home was rented to his employer by counting the office as one room out of nine and the garage as one-half room (but a room of lesser value). He then deducted 15 percent of the sums expended for insurance, utilities, city charges, pest control, repairs, and

maid service, which totaled $1,261. Petitioner calculated and claimed depreciation of $1,714, using as his basis for the office 15 percent of construction costs of the residence and the actual purchase price of the office furnishings.

OPINION

Section 280A(a)[1] provides the general rule that no deduction is allowable "with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence." Subsection (c) of section 280A lists exceptions to the general rule. The exceptions relevant to the parties' arguments are set forth below:

> SEC. 280A(c). EXCEPTIONS FOR CERTAIN BUSINESS OR RENTAL USE; LIMITATION ON DEDUCTIONS FOR SUCH USE.
>
> (1) CERTAIN BUSINESS USE.—Subsection (a) shall not apply to any item to the extent such item is allocable to a portion of the dwelling unit which is exclusively used on a regular basis—
>
> (A) [as] the principal place of business for any trade or business of the taxpayer,
>
> (B) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business, or
>
> (C) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business.
>
> In the case of an employee, the preceding sentence shall apply only if the exclusive use referred to in the preceding sentence is for the convenience of his employer.
>
> * * * * * * *
>
> (3) RENTAL USE.—Subsection (a) shall not apply to any item which is attributable to the rental of the dwelling unit or portion thereof (determined after the application of subsection (e)).

Subsection (e) requires a taxpayer who uses the dwelling unit for personal purposes during the taxable year, as a residence or otherwise, to limit his deductions to the amount determined after applying the percentage obtained by comparing the number of days the unit (or portion thereof) is rented to the total number of days the unit (or portion thereof) is used. *Bolton v. Commissioner*, 77 T.C. 104 (1981), affd. 694 F.2d

[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the year in issue.

556 (9th Cir. 1982). Paragraph (5) of section 280A(c) further limits the deduction authorized in case of rental use of a residence to the excess of the gross rental income over the portion of the expenses otherwise allowable (such as mortgage interest and taxes) that are attributable to the rental use. In other words, any net rental loss cannot be offset against unrelated income.

Petitioner claims the right to deduct the amounts in dispute on the basis of the exception provided in paragraph (3) of section 280A(c), i.e., the exclusion for rental use. Petitioner's argument is that he rented to another a portion of his home for the entire taxable year at fair rental value, thereby generating income, and therefore is entitled to reduce the rental income by the expenses attributable to its production.

Respondent does not deny that under section 280A a taxpayer may offset income attributable to the rental of a portion of his home with the costs of producing that rental income. He contends, however, that the rental arrangement here is an artifice arranged to disguise compensation as rental income in order to enable petitioner to avoid the strict requirements of section 280A(c)(1) for deducting home office expenses. Because there was no actual rental of a portion of the home, argues respondent, petitioner must qualify under section 280A(c)(1) before he may deduct the home office expenses. Respondent points to the close relationship of the parties to the rental agreement, the high rent, and petitioner's intimate knowledge of the literal requirements for deductibility under section 280A in support of his argument that the rental agreement "existed on paper only" and served no business purpose of the lessee.

Respondent is correct in asserting that the lessor and lessee herein dealt at less than arm's length and that the rent paid to petitioner was in excess of fair market value. These two facts do not necessarily destroy the bona fides of the rental arrangement, however. A close relationship between a lessor and lessee does not mean that a valid lease agreement between them cannot exist (*Kansas City Southern Railway v. Commissioner*, 76 T.C. 1067, 1102 (1981), on appeal (8th Cir., Oct. 25, 1982)), but it does require a careful examination of the circumstances surrounding the arrangement to determine whether the payments are, in fact, for the rental of property.

Davis v. Commissioner, 26 T.C. 49, 56 (1956). In so doing, we must attempt to determine what unrelated parties dealing at arm's length would have done under otherwise similar circumstances. *Utter-McKinley Mortuaries v. Commissioner*, 225 F.2d 870 (9th Cir. 1955), affg. a Memorandum Opinion of this Court.

Similarly, the payment of excessive rent does not necessarily taint the character of the entire payment. See, e.g., *Place v. Commissioner*, 17 T.C. 199 (1951), affd. 199 F.2d 373 (6th Cir. 1952); *Kansas City Southern Railway v. Commissioner*, *supra*, wherein only that amount beyond the reasonable rent was disallowed as a deduction for rent. Rather, the reasonableness of the payment is only one element to be considered in determining the ultimate issue, viz, whether the payments are being made for the continued use and occupancy of property. *Place v. Commissioner*, *supra*.[2] The burden of proof as to the reasonableness of the rent, as well as the nature of the payments, is on petitioner. Rule 142(a), Tax Court Rules of Practice and Procedure.

We are convinced that at least part of the payments made to petitioner as rent by the company were to compensate petitioner for the company's use and occupancy of space in petitioner's home. The evidence demonstrates that the work of the company demanded and received substantial amounts of petitioner's time, and it was in the company's best interests to provide petitioner with additional and more private office space. Problems of confidentiality and frequent interruptions made it necessary that such office space be away from petitioner's regular office on the company premises. In this regard, the case is somewhat unique; and this degree of business necessity goes far beyond the "appropriate and helpful" standard for deduction of home offices that created administrative problems and was intended to be eliminated by section 280A. See S. Rept. 94–938 (1976), 1976–3 C.B. (Vol. 3) 49, 185–186.

Although it may have been petitioner's idea to locate the office in his home, and he may have had both enough influence in the company to effectuate his idea and an understanding of the requirements of the Internal Revenue Code, we neverthe-

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[2] See also *Velvet Horn, Inc. v. Commissioner*, T.C. Memo. 1981–227; *Post Bros. Construction Co. v. Commissioner*, T.C. Memo. 1973–257; *Sparks Nugget, Inc. v. Commissioner*, T.C. Memo. 1970–74, affd. 458 F.2d 631 (9th Cir. 1972).

less conclude that the rental arrangement was bona fide. The company had a business necessity in providing petitioner with office space outside of company headquarters that was comfortable and convenient for petitioner. The most logical spot for that office was in petitioner's home. The fact that the location of the office was convenient to petitioner does not override the business purpose. See *Heineman v. Commissioner*, 82 T.C. 538, 544–545 (1984).

The parties entered into an agreement for the use of office space that set forth mutual benefits and burdens, and the payments for that use, to the extent they are reasonable, are properly designated as rent. There is no evidence in the record to suggest that the company would have paid the $5,400 to petitioner even if it had not leased the office. Because we have found that petitioner actually rented the office to the company, the costs of the office space were therefore "attributable to the rental of the dwelling unit or portion thereof." In these circumstances, the deductions are permitted under the literal language of section 280A. They would not be permitted, of course, if petitioner had not established that a clearly identifiable physical space was the subject of a lease; that such space had a determinable rental value; and that the deductions claimed were supported by proof of the costs attributable to the leased space. We have often applied equivalent tests in cases decided under section 162(a)(3), dealing with deduction of rent in trade or business contexts, including those cited above. We believe that the factual determinations required in concluding that a bona fide rental arrangement exists are an adequate assurance that the express statutory exception for rental use is not being abused.

Petitioner's deductions are limited, however, by section 280A(c)(5), to the amount of his gross income from the rental reduced by the portion of his deductions for mortgage interest and taxes allocable to the rental use.[8] It is therefore necessary to determine what portion of the payments was actually rent and what portion of the house was devoted to rental use.

A lease amount negotiated at arm's length will be presumed to be reasonable. *Potter Electric Signal & Manufacturing Co. v. Commissioner*, 286 F.2d 200 (8th Cir. 1961), affg. a Memoran-

[8] Petitioner rented the office for 365 days in 1979, so 100 percent of the expenses of the office are attributable to the rental. Sec. 280A(e).

dum Opinion of this Court. Because petitioner was an officer and shareholder of the company, however, we must look beyond the agreement of the parties to the lease to determine a reasonable rent. In finding a total value of $260 per month ($3,120 per year), we have relied on the testimony of petitioner's expert and respondent's expert, whose approximations of rental value did not vary substantially.

Both petitioner and respondent rely upon Rev. Rul. 62–180, 1962–2 C.B. 52, 54, for determining what portion of the home was devoted to the rental use. That ruling states:

> Where a portion of a residence is devoted to business purposes on a regular basis, the portion of the depreciation and other costs incurred in maintaining the residence, which is properly attributable to the space used in business, is a question of fact to be decided in each case. However, in making an allocation of expenses, it would, if the circumstances warrant, be proper to compare the number of rooms or square feet of space devoted to a business purpose to the total number of rooms or square feet in the residence and apply the ratio thus arrived at to the total of each of the expenses properly attributable to the use of part of the residence for business purposes. Such methods of allocation are not the only methods which may be made. Any other method which is reasonable under the circumstances will be acceptable.

Petitioner counted the rooms in his house and treated his office as one out of nine rooms and his garage space as one-half room, but a room of lesser value, to arrive at a figure of 15 percent as the portion of the house attributable to the rental. This method attributes over 11 percent of the house to the office, but the office actually comprised less than 6 percent of the usable square footage of the house. Respondent's expert compared the actual square footage of the office and the part of the garage used for parking petitioner's car to the total square footage of the house and concluded that 9 percent of the house was devoted to the rental use. This is the more precise method and is therefore the most reasonable method available here. Thus, only 9 percent of the basis of petitioner's home may be depreciated, and only 9 percent of the home expenses may be allocated to the rental use of the home. Petitioner must also reduce his gross rental income by 9 percent of his home mortgage interest and real estate taxes, under section

280A(c)(5), before taking the deductions allowable for rental use.

To reflect the foregoing,

Decision will be entered under Rule 155.

Reviewed by the Court.

DAWSON, FAY, STERRETT, GOFFE, CHABOT, NIMS, KÖRNER, SHIELDS, SWIFT, JACOBS, GERBER, and WRIGHT, *JJ.*, agree with the majority opinion.

WHITAKER, HAMBLEN, and CLAPP, *JJ.*, did not participate in the consideration of this case.

NIMS, *J.*, concurring: While I agree that this case falls within the language of section 280A(c)(3) (relating to "rental use"), I deem it essential to recognize the result for what it is, namely, one which follows from the facts as found by the trial judge, and nothing more. It may confidently be expected that close scrutiny will be given similar fact patterns in the future where the possibility of compensation disguised as rent may be present. Under such circumstances, the conditions for home office deductions provided by Congress in section 280A(c)(1) will, of course, apply.

CHABOT, COHEN, JACOBS, GERBER, and WRIGHT, *JJ.*, agree with this concurring opinion.

SIMPSON, *J.*, dissenting: It is easy to take a narrow view of the arrangement at issue in this case and conclude that it is nothing more than a lease described in section 280A(c)(3). However, in my judgment, it is our responsibility to take a broader view of the arrangement, to examine all the surrounding circumstances, and to recognize that the effect of the arrangement is to subvert the limitations of section 280A(c)(1) on the use of a personal residence for business purposes. Hence, I believe the deductions should be disallowed.

It is well settled that, generally, the tax consequences of a transaction are to be based upon its substance, not its form.

Gregory v. Helvering, 293 U.S. 465 (1935); *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945); *Helvering v. Clifford*, 309 U.S. 331 (1940). It is equally well settled that to determine the substance of a transaction, the various related steps must be judged together, not separately. *Gregory v. Helvering, supra*; *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 184–185 (1942); *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938). Form is too ephemeral; it is too subject to mistake or manipulation. *Schmitz v. Commissioner*, 51 T.C. 306 (1968), affd. sub nom. *Throndson v. Commissioner*, 457 F.2d 1022 (9th Cir. 1972); *Hook v. Commissioner*, 58 T.C. 267 (1972). Tax consequences, in fairness to both the taxpayer and the Commissioner, should be based on harder stuff.

In the venerable case of *Gregory v. Helvering, supra*, the taxpayer owned the stock of the old corporation. A new corporation was formed. The old corporation transferred some of its property to the new corporation, and the stock of the new corporation was issued to the taxpayer. Thereafter, the taxpayer liquidated the new corporation and received a distribution of the property. The taxpayer maintained that there was a tax-free corporate reorganization and that she received the property as a liquidating distribution. In his famous opinion (69 F.2d 809 (2d Cir. 1934)), Judge Learned Hand recognized that if the transactions were separated, they came within the literal terms of the statute. However, he observed:

> It is quite true * * * that as the articulation of a statute increases, the room for interpretation must contract; but the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create. * * * [69 F.2d at 810–811.]

Both the Supreme Court and Judge Hand refused to consider the transactions to be separate ones; they viewed them together and concluded that the statutory provisions were not intended to permit the conversion of a dividend into a liquidating distribution.

In *Helvering v. Clifford*, 309 U.S. 331 (1940), the Supreme Court again refused to recognize, for tax purposes, the niceties of legal transfers of property. The Court said:

> Technical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct as a refuge from surtaxes should not obscure the basic issue. * * * [309 U.S. at 334.]

The Court found that, despite a transfer in trust, the grantor continued, in substance, to be the owner of the property and taxable on its income. In a like manner, our hands are not tied by the form of the arrangement at issue; in applying the statutory provisions, we must consider all the provisions of section 280A and look to the substance of the arrangement.

Section 280A was enacted in response to the perceived "great need for definitive rules * * * governing the deductibility of expenses attributable to the maintenance of an office in the taxpayer's personal residence." S. Rept. 94–938 (1976), 1976–3 C.B. (Vol. 3) 49, 185; H. Rept. 94–658 (1975), 1976–3 C.B. (Vol. 2) 695, 852. Congress observed:

> In many cases the application of the appropriate and helpful test would appear to result in treating personal living, and family expenses which are directly attributable to the home (and therefore not deductible) as ordinary and necessary business expenses, even though those expenses did not result in additional or incremental costs incurred as a result of the business use of the home. * * * [H. Rept. 94–658, *supra*, 1976–3 C.B. at 852.]

See also S. Rept. 94–938, *supra*, 1976–3 C.B. (Vol. 3) at 185. To carry out the legislative purpose, section 280A denies a deduction, in the case of an individual, for all the expenses of a dwelling unit used as a residence, but other provisions of section 280A contain exceptions to that general rule. Section 280A(c)(1) deals with the use of a portion of the residence for business purposes and allows deductions when such portion is exclusively and regularly used:

> (A) [as] the principal place of business for any trade or business of the taxpayer,
>
> (B) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business, or
>
> (C) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business.

Another exception is set forth in section 280A(c)(3) for "the rental of the dwelling unit or portion thereof." The clear legislative purpose of these provisions is to deny the taxpayer a deduction for the expenses of maintaining his residence

unless those expenses are attributable to a use described in one of the specified exceptions.

Here, we have a purported lease of a portion of the residence, and if that arrangement is considered a lease, it comes within the terms of section 280A(c)(3). However, this was not a lease to a disinterested third person. It was a lease to the employer of the taxpayer, and as a result of the lease, the taxpayer used a portion of his residence to carry on his business activities. Thus, if we take into consideration the consequences of the lease, we find that we have a taxpayer using a portion of his residence for business purposes and claiming a deduction for the expenses of such use.

Generally, a taxpayer is not to be allowed a deduction for depreciation on his residence or for the expenses of maintaining that residence, unless the business use meets the specific conditions of section 280A(c)(1). Yet, by looking only at section 280A(c)(3), the majority of the Court allows this petitioner deductions for such purposes, without regard to whether his business use meets the conditions of section 280A(c)(1). The allowance of the deductions for depreciation and the other expenses of maintaining the residence attributable to the business use directly contravenes the purpose of section 280A(c)(1). It is no answer to say that the deductions are allowed to offset the rental income; if the deductions are considered from that point of view, then the employer of the petitioner is paying for the depreciation and maintenance of the petitioner's residence, without the petitioner being taxed on such benefits.

We are confronted with a situation in which the transaction at issue may be said to come within the terms of one provision of the statute, section 280A(c)(3), but in which the transaction clearly should be subject to another provision of the statute, section 280A(c)(1). The majority considers only the lease and the applicability of section 280A(c)(3). It is as if the *Gregory* Court had looked only at the liquidating distribution and the statutory provision pertaining to such distributions. However, as in *Gregory*, we should take into consideration all aspects of the transaction, not merely that it is a lease; we should also recognize that it is an arrangement under which a portion of the petitioner's residence is used to carry on his business. We should also, as in *Gregory*, take into consideration the various

applicable statutory provisions and construe them as a whole. When we take into consideration the entire statutory scheme for the treatment of the expenses of maintaining a residence, we should hold that a lease of a portion of the residence to the employer and the resulting use of such portion by the petitioner for business purposes must be examined in the light of the requirements of section 280A(c)(1). When those requirements are not satisfied, the expenses of the residence should not be deductible.

WILBUR and PARKER, *JJ.*, agree with this dissent.

PARKER, *J.*, dissenting: I join in Judge Simpson's dissenting opinion but wish to make an additional observation. Section 280A(a) lays down a general rule of nondeductibility of expenses "with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence." Section 280A(c) then creates four exceptions to the general rule and these four exceptions should be narrowly construed. The effect of the majority opinion is to convert the rental use exception of section 280A(c)(3) into "the great override," which would permit taxpayers to circumvent all of the carefully crafted limitations of the exception for business use (section 280A(c)(1)), the exception for storage use (section 280A(c)(2)), and the exception for day care services (section 280A(c)(4)). I do not believe the Congress intended, or the statute compels, such a perverse result.

SIMPSON, *J.*, agrees with this dissent.

HOCKADEN & ASSOCIATES, INC., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 8003-83. Filed January 9, 1985.

P obtained certain loans from its tax-exempt employee profit-sharing plan prior to Jan. 1, 1975, and the loans remained outstanding after that date. *Held*, P is liable for the excise taxes imposed by sec. 4975, I.R.C. 1954, with respect to such loans.

Held, further, sec. 4975, as applied to P's loans, does not constitute an ex post facto law.

Larry H. Snyder, for the petitioner.
Mark S. Feuer, for the respondent.

OPINION

COHEN, *Judge*: Respondent determined that petitioner is liable for excise taxes under section 4975(a)[1] as follows:

TYE Aug. 31—	*Amount*
1979	$498
1980	1,162
1981	1,724

Respondent also determined that an additional tax is due from petitioner under section 4975(b) in the amount of $120,876. The issues for decision are as follows: (1) Whether the excise taxes on prohibited transactions imposed by section 4975 apply to the balances outstanding during the years in issue on certain pre-1975 loans to petitioner from an employee profit-sharing plan established by petitioner, and (2) if so, whether such an application of section 4975 constitutes an ex post facto law in violation of article I, section 9 of the U.S. Constitution.

The facts have been fully stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Petitioner is a corporation and had its principal place of business in Ohio at the time of filing the petition herein. Petitioner had previously been known as Hockaden, Lipes, Rousculp, Inc., and as H.G. Dill Co. Petitioner and its predecessors shall hereinafter collectively be referred to as petitioner.

On August 30, 1964, petitioner established a profit-sharing plan for its employees which became known as the Hockaden & Associates, Inc. Profit Sharing Plan and Trust (the Hockaden Trust or the trust). On December 14, 1964, and on February 21, 1980, the Internal Revenue Service issued

[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

determination letters holding that the Hockaden Trust qualified as a tax-exempt plan under sections 401 and 501.

During the years 1971 through 1975, the Hockaden Trust lent money to petitioner, who administered the trust, as follows:

Date	*Amount*
3/ 9/71	$20,000
6/ 4/71	20,000
9/17/73	15,000
9/20/73	10,000
4/ 1/75	28,700

Each of the loans were reflected in a separate note that provided for interest at 6 percent per annum, payable annually, but did not specify any repayment date. Each loan was unsecured.

Petitioner paid no interest to the trust. The aggregate outstanding balance on the loans (including accrued interest) on the dates shown was as follows:

Date	*Balance*
8/31/78	$123,727.08
8/31/79	131,211.18
8/31/80	141,708.07
8/31/81	144,502.33
4/ 9/84	131,432.30

Added to the Code by title II of the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. 93–406, sec. 2003, 88 Stat. 829, 971, section 4975 imposes two levels of excise tax on any "disqualified person" who participates in a "prohibited transaction." Section 4975(a) provides for an initial tax equal to 5 percent of the amount involved with respect to the prohibited transaction. Section 4975(b) imposes an additional tax equal to 100 percent of the amount involved, if the prohibited transaction is not timely corrected.[2] For the

[2] As amended by the Act of Dec. 24, 1980, Pub. L. 96–596, 94 Stat. 3469, sec. 4975 (a) and (b) provides as follows:

SEC. 4975. TAX ON PROHIBITED TRANSACTIONS.

(a) INITIAL TAXES ON DISQUALIFIED PERSON.—There is hereby imposed a tax on each prohibited transaction. The rate of tax shall be equal to 5 percent of the amount involved with respect to the prohibited transaction for each year (or part thereof) in the taxable period. The tax imposed by this subsection shall be paid by any disqualified person who participates in the prohibited

purposes of section 4975, the term "prohibited transaction" includes any lending of money or other extension of credit between a disqualified person and a trust described in section 401(a) that is tax exempt under section 501(a). Sec. 4975(c)(1)(B) and (e)(1). The term "disqualified person" includes an employer whose employees are covered under the trust. Sec. 4975(e)(1) and (2).

Respondent determined that petitioner's borrowings from the Hockaden Trust constituted prohibited transaction subject to section 4975. Respondent concluded that the loans made before January 1, 1975, the general effective date of section 4975, were subject to the excise taxes because the loans remained outstanding on that date.

Petitioner does not deny that it is a "disqualified person" as defined in section 4975 or that the loan from the Hockaden Trust to petitioner on April 1, 1975, is a "prohibited transaction" subject to the excise taxes. Petitioner argues, however, that the loans made before the general effective date of section 4975 are not taxable. Petitioner first asserts that Congress did not intend that section 4975 apply to loans made prior to January 1, 1975. Petitioner alternatively asserts that the application of section 4975 to such loans would constitute an unconstitutional ex post facto law.[3]

To evaluate petitioner's first argument, we look initially to the express language of ERISA. Section 2003(c) of ERISA, in pertinent part, prescribes the effective date of section 4975 as follows:

> (c) EFFECTIVE DATE AND SAVINGS PROVISIONS.—
>
> (1)(A) The amendments made by this section shall take effect on January 1, 1975.

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transaction (other than a fiduciary acting only as such).

(b) ADDITIONAL TAXES ON DISQUALIFIED PERSON.—In any case in which an initial tax is imposed by subsection (a) on a prohibited transaction and the transaction is not corrected within the taxable period, there is hereby imposed a tax equal to 100 percent of the amount involved. The tax imposed by this subsection shall be paid by any disqualified person who participated in the prohibited transaction (other than a fiduciary acting only as such).

The above language is identical to that codified by ERISA, with the exception of the substitution of the term "taxable period" for the term "correction period" in sec. 4975(b). The 1980 Act cured a jurisdictional defect not in issue herein. Cf. *Howell v. Commissioner*, 77 T.C. 916 (1981); *Adams v. Commissioner*, 72 T.C. 81 (1979), affd. without published opinion 688 F.2d 815 (2d Cir. 1982).

[3] The petition also alleged a Fifth Amendment violation. Petitioner did not raise this issue in its brief, and we conclude that it has abandoned the argument for lack of merit.

(B) If, before the amendments made by this section take effect, an organization described in section 401(a) of the Internal Revenue Code of 1954 is denied exemption under section 501(a) of such Code by reason of section 503 of such Code, the denial of such exemption shall not apply if the disqualified person elects (in such manner and at such time as the Secretary or his delegate shall by regulations prescribe) to pay, with respect to the prohibited transaction (within the meaning of section 503(b) or (g)) which resulted in such denial of exemption, a tax in the amount and in the manner provided with respect to the tax imposed under section 4975 of such Code. An election made under this subparagraph, once made, shall be irrevocable. The Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this subparagraph.

(2) Section 4975 of the Internal Revenue Code of 1954 (relating to tax on prohibited transactions) shall not apply to—

(A) a loan of money or other extension of credit between a plan and a disqualified person under a binding contract in effect on July 1, 1974 (or pursuant to renewals of such a contract), until June 30, 1984, if such loan or other extension of credit remains at least as favorable to the plan as an arm's-length transaction with an unrelated party would be, and if the execution of the contract, the making of the loan, or the extension of credit was not, at the time of such execution, making, or extension, a prohibited transaction (within the meaning of section 503(b) of such Code or the corresponding provisions of prior law)* * *

Petitioner argues that paragraph (1)(B) above indicates that Congress did not intend that section 4975 apply to transactions occurring before January 1, 1975, unless the taxpayer so elects. An examination of the purposes of paragraph (1)(B) and a reading of the paragraph in conjunction with paragraph (2) reveals the fallacy of petitioner's argument.

Paragraph (1)(B) reflects Congress' desire that the sanction for engaging in a prohibited transaction fall upon the disqualified person and not the employee benefit plan. Prior to ERISA, section 503 denied tax-exempt status to a plan that engaged in a prohibited transaction. Recognizing that such a result might impose a hardship upon innocent employees, Congress replaced the disqualification rule with the excise tax on the disqualified person. Paragraph (1)(B) merely allows the election of post-ERISA treatment where the plan has previously been disqualified under pre-ERISA law. See Conf. Rept. 93–1280 (1974), 1974–3 C.B. 415, 483.

In contrast to paragraph (1)(B), paragraph (2) addresses the issue herein, i.e., the applicability of section 4975 to conduct begun before the general effective date of the section that continues after such date. Paragraph (2)(A) exempts from

section 4975 a loan under a binding contract in effect on July 1, 1974, if the loan remains at least as favorable to the plan as an arm's-length transaction and if the loan was not a "prohibited transaction" within the meaning of section 503(b) when made. It thus appears that Congress intended section 4975 to apply to loans outstanding on January 1, 1975, if the specific conditions of paragraph (2)(A) are not satisfied.

The Conference report accompanying ERISA confirms that the exemption from section 4975 is available only if the outstanding loans did not constitute prohibited transactions under pre-ERISA law:

> To prevent undue hardship, the substitute also provides transition rules for situations where employee benefit plans are now engaging in activities which do not violate current law, but would be prohibited transactions under substitute.
>
> One of the transition rules permits the leasing or joint use of property involving a plan and a party in interest under a binding contract in effect on July 1, 1974 (or pursuant to renewals of the contract), to continue for 10 years beyond that date until June 30, 1984. For this transition rule to apply, the lease or joint use must remain at least as favorable to the plan as an arm's-length transaction with an unrelated party and must not otherwise be a prohibited transaction under present law. A similar 10-year transition rule applies to loans or other extensions of credit under a binding contract in effect on July 1, 1974 (and renewals thereof), where the loan remains as favorable as an arm's-length transaction with an unrelated party and is not prohibited under present law. [Conf. Rept. 93–1280, *supra*, 1974–3 C.B. at 486.]

Petitioner does not argue that the loans in issue qualify for the exemption under paragraph (2)(A), and such an agreement would be futile. Section 503(b), as it existed before January 1, 1975, defined a "prohibited transaction" for the purposes of section 503 to include a loan to the creator of a section 401(a) trust without receipt of adequate security. Each of the loans from the Hockaden Trust to petitioner, creator of the trust, were unsecured.

Petitioner, instead, denies that section 2003(c)(2)(A) of ERISA deals with loans made before the general effective date of section 4975. It argues that the transitional provision only relates to loans made after January 1, 1975, on the basis of a binding contract in existence on July 1, 1974. Petitioner thus concludes that paragraph (2)(A) is only applicable to contracts

to make a loan, not loans actually made, prior to the effective date of section 4975.

Petitioner's argument is not supported by the express language of the statute, is inconsistent with congressional intent behind section 2003(c)(2)(A) of ERISA, and is illogical. The second condition in subparagraph (A)—"if the execution of the contract, *the making of the loan*, or the extension of credit *was* not, at the time of such execution, *making*, or extension, a prohibited transaction (within the meaning of section 503(b)" (emphasis supplied)—obviously assumes that the transitional provision applies to a loan actually made before the effective date of section 4975.

Congress did not distinguish between an executory contract to make a loan and an executed loan contract, and justification for such a distinction has not been suggested by petitioner and is not apparent. As petitioner admits, section 2003(c)(2)(A) of ERISA "is a transitional provision or rule intended to prevent undue hardship to trusts and plans engaged in activities or courses of conduct lawful at the time of inception but made suddenly unlawful under ERISA." This reasoning applies at least as much to executed loan agreements as to executory contracts. Where, as in the present case, the loans constituted prohibited transactions under pre-ERISA law, transitional relief is not necessitated by equitable considerations and has not been provided.

Petitioner asserts generally that "ERISA was intended to operate prospectively only" and cites cases holding that various provisions of title I of ERISA do not apply where the event on which the plaintiff bases his claim occurred before the effective date of the relevant provision. See, e.g., *Reuther v. Trustees of Trucking Employees of Passaic and Bergen County Welfare Fund*, 575 F.2d 1074 (3d Cir. 1978); *Martin v. Bankers Trust Co.*, 565 F.2d 1276 (4th Cir. 1977); *Morgan v. Laborers Pension Trust Fund for Northern California*, 433 F. Supp. 518 (N.D. Cal. 1977).

Applying section 4975 to the loans in the present case, however, does not constitute a retroactive application of ERISA. The event giving rise to petitioner's liability under section 4975 is not petitioner's obtaining loans from the trust prior to January 1, 1975, but petitioner's maintaining the loans after that date. As the case law under title I illustrates,

imposing the tax upon petitioner's post-1975 conduct involves a prospective application of ERISA.[4]

In *Morrissey v. Curran*, 567 F.2d 546 (2d Cir. 1977), the plaintiff alleged that the defendant plan administrator purchased an imprudent investment prior to the effective date of the fiduciary responsibility rules. Although the court stated that the provisions of ERISA are not retroactive, the court held that the failure to liquidate an unwise investment within a reasonable time after the fiduciary responsibility provisions became effective would constitute an ERISA violation. The court thus recognized that pre-ERISA conduct might involve a "continuing wrongdoing" for which the defendant would be liable. *Morrissey v. Curran*, 567 F.2d at 547–548.

In both *Freund v. Marshall & Ilsley Bank*, 485 F. Supp. 629 (W.D. Wis. 1979), and *Donovan v. Bryans*, 566 F. Supp. 1258 (E.D. Pa. 1983), the courts applied the rule of *Morrissey* to "prohibited" loans made before the effective date of the fiduciary responsibility provisions but remaining outstanding after that date. The courts held that, although the making of the loans did not constitute an ERISA violation, the maintenance of the loans after the effective date of ERISA is prohibited by the fiduciary responsibility rules. As the court in *Donovan* stated:

> In reaching its determination, the court [in *Freund*] explained that it does not constitute a retroactive application of ERISA to apply ERISA's fiduciary standards to the post-ERISA maintenance of an investment that was originally made prior to ERISA. * * * Since *Freund*, the courts have simply accepted without question that ERISA does not insulate loans made to parties in interest merely because they were made prior to January 1, 1975. * * * [566 F. Supp. at 1263.]

See also *Pension Benefit Guaranty Corp. v. Greene*, 570 F. Supp. 1483 (W.D. Pa. 1983), affd. without published opinion 727 F.2d 1100 (3d Cir. 1984).

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[4] Tit. I of ERISA contains various provisions regulating employee benefit plans. Part 4 of tit. I (secs. 401 through 414) prescribes rules of fiduciary responsibility. In defining and proscribing certain "prohibited transactions," sec. 406 of ERISA generally parallels Code sec. 4975. See Conf. Rept. 93-1280 (1974), 1974-3 C.B. 415, 467. Thus ERISA sec. 406(a)(1)(B) prohibits the lending of money or other extension of credit between a plan and a party in interest. The general effective date of the fiduciary responsibility provisions is Jan. 1, 1975. ERISA, sec. 414(a). Sec. 414(c)(1), however, provides a transitional exemption from sec. 406 that is virtually identical to sec. 2003(c)(2)(A) with respect to Code sec. 4975.

Our conclusion that the application of section 4975 to petitioner's loans does not constitute a retroactive application of ERISA also disposes of petitioner's ex post facto argument. The ex post facto clause prohibits only the retroactive penalizing of past conduct. The prohibition does not apply to the imposition of a penalty for the continuation of conduct that previously was not subject to the penalty. *Samuels v. McCurdy*, 267 U.S. 188 (1925); *Chicago & Alton Railroad v. Tranbarger*, 238 U.S. 67 (1915).

We note that petitioner can avoid payment of the section 4975(b) tax by correcting the prohibited loans before our decision herein becomes final. Secs. 4961 and 4962.

To reflect stipulations by the parties,

Decision will be entered under Rule 155.

WARSAW PHOTOGRAPHIC ASSOCIATES, INC., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 2113-79. Filed January 14, 1985.

Ten shareholders of S, holding about 20 percent of S's common stock and none of its preferred, created a new corporation, P. The 10 shareholders' S common stock holdings ranged from about 1 percent to about 4 percent; their P stock holdings were each 10 percent. Pursuant to a plan, (a) S transferred substantially all of its assets to P, and (b) P transferred $21,000 to S, P assumed S's obligations under certain leases and with respect to work in progress, and P issued additional shares of its stock to the 10 shareholders. These additional shares were in proportion to the 10 shareholders' holdings in P and not to their holdings in S. *Held*:

1. The transaction is not a D reorganization, because it failed to comply with the requirements of secs. 368(a)(1)(D) and 354(b)(1), I.R.C. 1954, regarding distribution of stock. Liquidation-reincorporation cases are distinguished. P is not entitled to deduct S's net operating losses and is not entitled to compute depreciation on S's bases in the transferred depreciable assets.

2. P is not entitled to increase its bases in the transferred assets on account of the fair market value of the additional shares issued to the 10 shareholders.

P incurred certain legal expenses in connection with the organization of P and the transaction with S. P deducted the full

amounts of these expenses on its income tax return for the year of its incorporation.

3. P is not entitled to amortize these amounts under sec. 248, I.R.C. 1954, because P failed to make any election in the form required by the regulations under this section; P's deduction on its income tax return is inconsistent with any possible election under this section.

4. Those amounts to which sec. 248, I.R.C. 1954, does not apply are to be added to the bases of certain 10-year assets, and depreciation deductions and investment credit are to be recomputed.

P entered into a purchase and sale agreement with C and with MP, an executive of C. Part of the agreement was MP's covenant not to compete for a stated term of 6 years. P paid the consideration for this covenant over a period of 31 months.

5. P's payments for the covenant not to compete are amortizable and deductible over the covenant's life (6 years) and not over the period the payments were made (31 months).

Robert A. Jacobs, Nicholas J. Creme, and *Lewis Kurfist*, for the petitioner.

Richard M. Campbell and *Kevin C. Reilly*, for the respondent.

CHABOT, *Judge*: Respondent determined deficiencies in Federal corporate income tax against petitioner for its taxable years ended June 30, 1974,[1] June 30, 1975, and June 30, 1976, in the amounts of $70,040, $58,239, and $34,685, respectively.

After concessions by both sides, the issues for decision are as follows:

(1) Whether a transaction involving a transfer of assets to petitioner qualifies as a reorganization under section 368(a)(1)(D),[2] thereby entitling petitioner to succeed to the transferor's net operating losses under section 381(a)(2), and giving petitioner a carryover basis (under sec. 362) in the assets acquired from the transferor.[3]

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[1] Unless indicated otherwise, all references to taxable years are to petitioner's fiscal years ended June 30.

[2] Unless indicated otherwise, all section, subchapter, and chapter references are to sections, subchapters, and chapters of the Internal Revenue Code of 1954 as in effect for the years in issue.

[3] In his answer, respondent concedes that if we conclude that the transfer qualifies as a D reorganization, then there are no deficiencies for petitioner's taxable years 1974 and 1975. As to petitioner's taxable year 1976, however, respondent raises a new matter in his answer. Respondent asserts that the net operating loss claimed in fiscal year 1976 "fails to qualify as a net operating loss carryover under section 381." At trial, respondent conceded this new matter.

(2) If the transfer does not qualify as a reorganization, then whether petitioner is entitled to increase its bases in the assets transferred to it, on account of the fair market value of its shares issued in connection with the transfer.

(3) Whether legal fees incurred by petitioner in acquiring Studios' assets are organizational expenses, and whether petitioner made an election under section 248 to amortize them.

(4) Whether petitioner must amortize the price of a covenant not to compete over its stated term, 6 years, or over the shorter period in which the total actual payment was made, 31 months.

FINDINGS OF FACT

Some of the facts have been stipulated; the stipulation and the stipulated exhibits are incorporated herein by this reference.

When the petition was filed in the instant case, petitioner's principal office was in New York, NY.

Transfer of Assets

From 1935 or earlier, Warsaw Studios, Inc. (hereinafter sometimes referred to as Studios),[4] and its predecessors were engaged actively in the commercial photography business. Studios was so engaged until July 2, 1973. Studios' principal business was photography for sales catalogues; its clients included Sears, Roebuck & Co., Spiegel, Montgomery Ward, J.C. Penney, and Avon.

A certificate of incorporation for Studios was filed with the New York Department of State on June 30, 1964. Amendments to this certificate of incorporation were filed on December 28, 1964, and June 30, 1965. By the amendment filed June 30, 1965, Studios increased the number of its authorized shares by 5,250 shares, making the aggregate number of authorized

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[4] At a special meeting of Studios' board of directors, on June 27, 1973, the directors agreed to amend the certificate of incorporation to reflect a change in Studios' name to "WRSW, Inc." This was done in order to allow Pegasus Studio, Ltd., a corporation organized by 10 of Studios' record shareholders and the predecessor of petitioner, to change its name to "Warsaw Photographic Associates, Inc.," under New York corporate law and not be in conflict with the name of Studios (i.e., the use of "Warsaw" by both Studios and Pegasus Studios, Ltd., might be considered a conflict). See note 13 *infra*, and the text preceding note 9 *infra*.

shares 15,500. This amendment further provides that 15,000 of these shares are common shares with $1 par value. The remaining 500 shares are cumulative preferred with $1,000 par value. The cumulative dividends are at the rate of 3 percent, annually. Before any dividend may be declared for common shareholders for a year, Studios would have to pay a 2-percent dividend to the preferred shareholders for that year, in addition to the cumulative 3-percent dividend to the preferred shareholders.

As of July 1, 1965, Studios had 325 outstanding shares of preferred stock, which had a total par value of $325,000. Warsaw & Co., Inc., a corporation owned solely by J.J. Warsaw,[5] was the record owner of all of Studios' preferred stock.

By the end of July 1965, Studios' common stock was owned as set forth in table 1.

TABLE 1

Owner	*Number of common shares*
Warsaw & Co., Inc	7,549
Paul Diethelm	375
Woodbury Prentiss	250
Gilbert S. Shawn	250
Donald Riley	200
Kyril Bromley	172
John Basilion	162
James McFarline	155
James V. Oliver	142
Joseph G. Lewandowski	134
Albert T. Warsaw	128
David Martin	128
Stephen Warsaw	88
Richard Dennis	175
Winfield S. Sinn, Jr	92

The shares owned by Albert T. Warsaw were repurchased by Studios; his stock certificate was canceled on March 17, 1970.

The shares owned by Kyril Bromley were redeemed on or about April 19, 1973.

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[5] J.J. Warsaw was also the chairman of the board of directors of Studios. He became physically incapacitated in 1973 when he suffered a stroke; he was not mentally incapacitated.

The shares owned by Paul Diethelm and Woodbury Prentiss were transferred to William J. Zad and Stephen Neil, respectively, on or about June 1, 1973.[6]

James McFarline and Stephen Warsaw stopped being shareholders before June 27, 1973.[7]

The following Studios shareholders were also employees of Studios: Gilbert S. Shawn; H. Donald Riley; John Basilion; James V. Oliver; Joseph C. Lewandowski; David Martin; Winfield S. Sinn, Jr.; William J. Zad; Richard Dennis; and Stephen Neil. These shareholders are hereinafter sometimes referred to individually as: "Shawn", "Riley", "Basilion", "Oliver", "Lewandowski", "Martin", "Sinn", "Zad", "Dennis", and "Neil", respectively, and hereinafter sometimes referred to collectively as "the 10 shareholders".

Studios leased office space at two locations in Manhattan, NY. One of these locations was in a building known as 183 Madison Avenue and 40 East 34th Street. The lease (hereinafter sometimes referred to as the 34th Street lease) for this space was for a term of 10 years and 5 months, to begin May 1, 1970, and to continue through September 30, 1980. The 34th Street lease was a standard form of office lease requiring Studios to pay a base annual rent of $17,800, plus, among other things, the following:

1. Additional rent equal to 1.5 percent of the increase in real estate taxes levied or imposed by the State or local governments, over the taxes "assessed for the tax year 1970/1971."

2. Additional rent equal to 1.5 percent of the increase in the amount of the building payroll and cleaning expenses, over such expenses for the calendar year 1970.

3. Additional sums for increases in the Lessor's cost of supplying electricity. This was to take the form of an increase in the annual base rent.[8]

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[6] Studios' stock certificate book contains forms indicating these transfers. The forms upon which these transfers are recorded do not recite whether any consideration was given, and the parties do not enlighten us on this matter.

[7] These shareholders, who were listed as record owners of shares of Studios' common stock in the stock book, did not sign a unanimous consent of "all of the shareholders" of Studios dated June 27, 1973. Thus, we presume that sometime before June 27, 1973, these persons ceased being shareholders of Studios. The parties do not enlighten the Court as to how this happened—i.e., redemption or sale. Consequently, we do not make a finding as to the total number of outstanding shares of common stock on the date of the transfer of assets from Studios to petitioner.

[8] The lessor reserved the right to discontinue furnishing electricity. If the lessor exercised this right, the lease was to continue in effect, the rent was to be reduced, and the lessee (Studios) was to arrange to get electricity from the public utility company.

Studios, as a lessee, had the right to sublease the office space during the term of the lease, but only with the lessor's consent. If Studios were to default, then all of the rent for the remaining term of the 34th Street lease would become due (reduced by any amounts received by the lessor if the lessor chose to relet the space).

In connection with the 34th Street lease, Studios obtained an irrevocable letter of credit issued by the Irving Trust Co. (hereinafter sometimes referred to as the bank) to Cross & Brown Co., the lessor under the 34th Street lease, in the amount of $100,000. J.J. Warsaw personally guaranteed this liability.

The other office space location was in a building known as 36 East 31st Street. Studios entered into three leases (hereinafter sometimes referred to as the 31st Street leases) with the 443 Fourth Avenue Corp. for various parts of the building, as reflected in table 2.

TABLE 2

	Lease Term		
Leased space	*Beginning*	*Ending*	*Annual rent*
Store, mezzanine, and basement	10/1/70	1/31/76	$50,000
Front portion of fourth floor	10/1/70	1/31/76	13,000
Rear portion of fourth floor	2/ 1/71	1/31/76	12,000

Studios employed relatives and a friend of J.J. Warsaw. Also, Studios had on its payroll the captain of a yacht which J.J. Warsaw owned and used for entertaining. Studios had sustained net operating losses before July 1, 1973, due in large part to the 34th Street lease and payroll commitments beyond its means.

Sometime about May 1973, J.J. Warsaw discussed with Shawn the possible sale of Studios. He made a serious offer of $400,000 to Shawn. Shawn rejected the offer.

Shawn thought that Studios could be made profitable if it could get out of the 34th Street lease which Shawn considered "debilitating" and if the number of employees could be reduced. Shawn obtained legal advice on how to do this.

Acting on legal advice, the 10 shareholders decided to organize a new corporation. On June 29, 1973, a corporation was incorporated under New York law under the name of Pegasus Studio, Ltd. (See note 4 *supra*.) Three days later, on

July 2, 1973, the directors and shareholders of this corporation met and unanimously approved a resolution to amend the certificate of incorporation to change the corporation's name to Warsaw Photographic Associates, Inc. (This corporation is the petitioner in the instant case.) Also, at this meeting, a plan for the issuance of common stock pursuant to section 1244 was adopted, effective June 29, 1973, and a form of subscription agreement was approved. Each of the 10 shareholders[9] subscribed to and paid for 100 shares of common stock (par value of $0.05) for $100 per share, or a total price of $10,000 for 100 shares. The total number of shares issued on petitioner's incorporation was 1,000 shares (hereinafter sometimes referred to as the 1,000 shares), for a total capital of $100,000.[10]

At this meeting, the officers of petitioner were elected as reflected in table 3.

TABLE 3

Name	*Office*
Shawn[11]	President
Riley[11]	Executive Vice President
Dennis[11]	Vice President
Basilion[11]	Vice President
Martin[11]	Vice President
Chester Sliwak	Secretary and Treasurer
Robert A. Jacobs[11]	Assistant Secretary
Raymond A. Mantle	Assistant Secretary

At this meeting, petitioner adopted a plan whereby Studios was to transfer all of its operating assets[12] to petitioner. In connection with this plan, the 10 shareholders, who were also shareholders of Studios, were to each receive directly 10

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[9]Dennis subscribed together with Anna Dennis, with right of survivorship.

[10]The directors and shareholders also authorized petitioner's treasurer to "credit the stated capital account of [petitioner] with $0.05 per share, aggregating $50 and to credit the capital surplus account of [petitioner] with $99.95 per share, aggregating $99,950." On its corporate income tax returns filed for taxable years 1974, 1975, and 1976, however, petitioner listed $100,000 as stated capital and did not list any capital surplus.

[11]These officers were also directors.

[12]Petitioner understood the operating assets of Studios to consist of: "(1) the right to use [Studios'] corporate name [i.e., Warsaw Studios, Inc.] or a similar name for purposes of conducting business in the state of New York; (2) [Studios'] goodwill, customer lists and all incidents relating to the conduct of its business; (3) all of [Studios'] rights under a certain lease of office space at 36 East 31 Street, New York City [i.e., the 31st Street lease]; (4) all of [Studios'] photographic and industrial supplies; and (5) all of [Studios'] furnishings and equipment, including cameras, developing equipment and office furnishings (excluding, however [Studios'] telephone system installed at 40 East 34 Street, New York City [i.e., the 34th Street lease], and [Studios'] computer which is no longer used in [Studios'] business."

additional shares of petitioner's common stock.[13]

On June 27, 1973, Studios' board of directors held a special meeting at which they adopted a plan of reorganization. Studios' directors understood the reorganization to involve a transfer of substantially all its assets to petitioner and the issuance by petitioner of 100 shares of its stock (hereinafter sometimes referred to as the 100 shares) directly to the 10 shareholders. Studios' understanding of "substantially all of its assets" is the same as petitioner's understanding of all of Studios' operating assets (see note 12 *supra*). As part of this plan, the 10 shareholders were to surrender their stock in Studios for cancellation.

On July 2, 1973, Studios and petitioner entered into a written agreement of "REORGANIZATION, SALE and PURCHASE" which provides in relevant part as follows:

WITNESSETH:

WHEREAS, the Buyer [petitioner] wishes to acquire (1) the right to use the Seller's [Studios'] name or similar name for certain purposes; (2) the Seller's goodwill; (3) the rights under a lease of office space at 36 East 31st Street, New York; (4) certain film and industrial supplies (the "Film and Supplies"); and (5) all of the furnishings and equipment of the Seller, including, without limitation, cameras, developing equipment and office furnishings, but excluding the Seller's telephone system and computer (such furnishings and equipment hereinafter referred to as the "Furnishings and Equipment") (the "Film and Supplies" and the "Furnishings and Equipment" hereinafter collectively referred to as the "Assets"), in exchange for the issuance of certain shares of the Buyer's stock to certain of the Seller's shareholders, the payment of certain sums of money and the assumption of certain obligations of Seller;

* * * * * * *

3. *Sale and Transfer of Property.*

(a) *Sale and Transfer.* (A) Subject to the terms and conditions of this Agreement, the Seller is hereby selling, conveying, ceding, transferring and delivering to the Buyer, and the Buyer is hereby accepting, (a) all of the Seller's right, title and interest in and to the Film and Supplies, (b) all of the Seller's right, title and interest in and to the Furnishings and Equipment, (c) the right to the use of the name "Warsaw Studios, Inc." or a similar name in the State of New York for the purpose of conducting a photography business,

[13] The record does not include any evidence that these additional shares were issued, and that they were issued directly to the 10 shareholders. However, both sides apparently assume on brief that these additional shares were so issued, and we so find.

(d) the goodwill of the Seller, and (e) all of the right, title and interest of the Seller in and to the 31st Street Lease.

(b) *Consideration for Sale and Transfer.* Subject to the terms and conditions of this Agreement, in full consideration for the aforesaid sale, conveyance, cession, transfer and delivery,

(1) The Buyer is hereby issuing 10 shares of Common Stock, $.05 par value, of the Buyer to each of the shareholders of the Seller other than Warsaw & Co., Inc. who are the only shareholders of the Buyer.

(2) No later than ten days from the date hereof, the Buyer will deliver to the Seller a check in New York Clearing House Funds in the amount of $1,000, representing payment in full for the Film and Supplies;

(3) No later than ten days from the date hereof, the Buyer will deliver to the Seller a check in New York Clearing House Funds in the amount of $5,000, representing partial payment for the Furnishings and Equipment and the other rights conveyed hereby;

(4) No later than 120 days from the date hereof, the Buyer will deliver to the Seller a check in New York Clearing House Funds in the amount of $5,000, representing partial payment for the Furnishings and Equipment and the other rights conveyed hereby;

(5) No later than 165 days from the date hereof, the Buyer will deliver to the Seller a check in New York Clearing House Funds in the amount of $5,000, representing partial payment for the Furnishings and Equipment and the other rights conveyed hereby;

(6) No later than 210 days from the date hereof, the Buyer will deliver to the Seller a check in New York Clearing House Funds in the amount of $5,000, representing payment in full for the Furnishings and Equipment and the other rights conveyed hereby;

(7) The Buyer is hereby assuming and agreeing to perform (a) all of the Seller's obligations under the 31st Street Lease; and (b) all of the Seller's liabilities and obligations to customers arising out of the ordinary course of business of the Seller through the date hereof, including, without limitation, (a) liabilities to customers in connection with the completion of work in process, (b) liabilities and obligations arising with respect to warranties of products to customers, and (c) the Seller's obligation to return to its customers all property of such customers currently held by the Seller.

In addition to this written agreement, Studios and petitioner executed five more documents on July 2, 1973. In the first, entitled "CONVEYANCE AND ASSIGNMENT", Studios agreed "for and in consideration of $1.00 and other good and valuable consideration" to transfer the agreed-upon assets to petitioner. In the second, entitled "UNDERTAKING", petitioner agreed to "assume and * * * pay, perform and discharge" all of Studios' obligations under the 31st Street leases and all of Studios' liabilities and obligations arising out of the ordinary course of business. The third is an assignment of Studios' "right, title and interest" in the 31st Street leases to petitioner. The fourth

is a security agreement. The fifth is a Uniform Commercial Code Financing Statement with regard to all equipment and furnishings at 40 East 34th Street and 36 East 31st Street, excluding films and industrial supplies.

Studios transferred to petitioner the assets to fully equip 10 photography studios, as well as assets used in Studios' bookkeeping office, fitting rooms, carpentry shop, storage center, and shipping room. The furnishings and equipment transferred from Studios to petitioner have a useful life of 10 years and include the following:

1. *Photography studios*: Cameras (including a Deardorff camera), enlargers (including a Saltzman enlarger), camera filters, stands, desks, lights (including strobe, keg, and Ascor lights), a hot press, cutting equipment, cabinets, partitions, shelving, Paz 1 converter, darkroom equipment (e.g., trays and tanks), film holders, color laboratory equipment (including a spectrograph), movable wooden folders, and light boxes.
2. *Bookkeeping office*: Desks and adding machines.
3. *Fitting room*: Stands, mirrors, and sewing machines.
4. *Carpentry shop*: Drill press, band saws, and table top saws.
5. *Storage center and shipping room*: Conveyor, shelving, wrapping paper, stands, scales, and tape machines.
6. *Miscellaneous fixed assets*: Photostat machine, furniture (including stools and chairs), refrigerators, and an electric range.

The value of the assets to be transferred by Studios was discussed among and negotiated by the executive employees of Studios, some of whom were also shareholders of petitioner. Shawn, then president of both Studios and petitioner, wrote a letter, dated July 2, 1973, to Studios' counsel confirming that in his opinion $20,000 for all of Studios' equipment was fair to both parties. In this letter, Shawn stated that "we have assured you that the value ascribed to the equipment is fair—not less than that which would have been realized had the equipment been sold to another purchaser under any conditions known to us at this time." The results of the discussion about value of the assets were brought to the attention of J.J. Warsaw at his home to ascertain his views as to whether the figures agreed on were fair and correct.

Studios could not get more than $20,000 for the equipment if it were sold at a forced sale to any third party and probably would get much less. A forced sale would be handled in a manner similar to an auction. Interested buyers would walk up to "auctioneers"—i.e., representatives of the seller—and make an offer. However, there would not be bidding. Buyers

would not receive receipts. Usually, the assets would be sold at low prices because the auctioneers would want to clean out the premises of the seller as quickly as possible. The transaction between petitioner and Studios was not a forced sale.

Studios contracted with petitioner to also transfer its goodwill. In the negotiations leading to the transaction between petitioner and Studios, the focus was not on the goodwill or going-concern value of Studios' business. Studios' creditors could not have forced Studios' employees to continue to work for Studios. Seventy-five of Studios' 126 employees were hired by petitioner when Studios transferred the assets to petitioner.

Studios assigned all its right, title, and interest in the 31st Street leases but did not assign its right, title, and interest in the 34th Street lease.

Petitioner agreed to complete Studios' work in progress and assume Studios' liabilities to customers in connection with this work as well as with regard to warranties of products and customers. As of July 2, 1973, Studios' work in progress had cost about $70,000. Petitioner spent about $70,000 to complete this work in progress and received about $150,000 therefor from its customers. As of July 2, 1973, this work in progress was of no value to Studios in its then-uncompleted state. Studios kept its computer and telephones, as well as cash and accounts receivable, to be used to pay its creditors.

On or about July 17, 1973, the lessor under the 34th Street lease sued on account of Studios' nonpayment of the July 1973 rent under this lease.

On July 23, 1973, Studios made a general assignment for the benefit of creditors. The assignee, Stanley S. Horvath (hereinafter sometimes referred to as Horvath), did not try to set aside Studios' transfer of assets to petitioner, because Horvath believed that petitioner had paid fair consideration for these assets. Horvath has not made any payment to Studios' creditors or to Warsaw & Co., Inc., the owner of all the outstanding preferred stock and 7,549 shares of the outstanding common stock. (See table 1 *supra*.)

On or about March 20, 1975, Studios filed its Federal corporate income tax return for its taxable year ending June 30, 1973. On this tax return, Studios claimed a net operating loss of $262,727. On or about March 20, 1975, Studios filed its tax return for the short period July 1 through July 24, 1973.

On this tax return, Studios claimed a net operating loss of $101,221 which, when added to the previous year's loss, made a total of $363,948. On or about March 17, 1975, petitioner filed its tax return for its taxable year 1974, on which it deducted this $363,948.

The 100 shares did not constitute part of the consideration paid by petitioner to Studios in exchange for substantially all of Studios' assets.

Legal Expenses

During its taxable year 1974, petitioner paid and incurred certain legal expenses, including $942 as an organizational expense and $3,400 in connection with the consummation of the transaction between Studios and petitioner under the written agreement of July 2, 1973. Both the $942 and the $3,400 were deducted in full on petitioner's 1974 taxable year tax return.

Petitioner did not file a statement with its tax returns for taxable years 1974, 1975, and 1976, setting forth: (1) The description and amount of either its organizational expenses or the expenses paid or incurred in connection with the transaction with Studios; (2) the month in which petitioner began business; and (3) the number of months over which such expenses were to be deducted ratably.

Covenant Not To Compete

Petitioner entered into an agreement of purchase and sale dated December 20, 1973, with Color Masters, Inc. (hereinafter sometimes referred to as Color Masters), a New York corporation, and Michael Pelio (hereinafter sometimes referred to as Pelio), the principal executive of Color Masters.

Under this agreement, Pelio covenanted not to compete with petitioner in the business of color film processing "in any part of the City of New York or the Metropolitan New York Area" for a period of 6 years, beginning on the closing date of the agreement. Pelio and petitioner further agreed to the following remedies for Pelio's violation of the covenant:

8.2 *Remedies for Violation.* If any of the restrictions on competitive activities contained in section 8.1 shall for any reason be held excessively broad it shall be construed by limiting and reducing it, so as to be

enforceable to the extent compatible with the applicable law as it shall then appear, it being understood that at the time of execution of this agreement the parties hereto regard said restrictions as reasonable and compatible with their respective rights. [Petitioner] and Pelio agree that a violation of the foregoing covenant not to compete, or of any provisions thereof, will cause irreparable injury to [petitioner] and its subsidiaries, if any, and that [petitioner] shall be entitled, in addition to any other rights and remedies it may have, at law or in equity, to an injunction enjoining and restraining Pelio from doing or continuing to do any such act and any other violations or threatened violations of this section 8.

As consideration for Pelio's covenant, petitioner agreed to pay Pelio $31,000, payable in 31 monthly installments of $1,000, each. Petitioner paid Pelio $3,000, $12,000, and $12,000 during its taxable years 1974, 1975, and 1976, respectively, and deducted these amounts on its tax returns for those years. Respondent partially disallowed these deductions. In the notice of deficiency in the instant case, respondent allowed deductions for these payments in the amounts of $2,583, $5,166, and $5,166, for the taxable years 1974, 1975, and 1976, respectively.

The life of the covenant not to compete is 6 years.

OPINION

I. D Reorganization

Ordinarily, a corporation is a separate entity for Federal income tax purposes; its tax attributes are not combined with those of its shareholders or other corporations. One of the major exceptions to this normal rule is part of the complex of provisions relating to corporate reorganizations,[14] in particular that part of the complex that allows a corporation to use for income tax purposes certain parts of the income tax history of another corporation.

Corporate reorganizations, as defined in one or another of the subparagraphs of section 368(a)(1), qualify for special treatment for Federal income tax purposes under certain rules. The dispute in the instant case is as to whether petitioner is entitled to the special treatment provided under

[14] Other major exceptions are subch. S (sec. 1361 et seq.) and ch. 6 (sec. 1501 et seq.). See generally B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, par. 1.05, at 1-14 et seq. (4th ed. 1979), hereinafter sometimes referred to as Bittker & Eustice.

two of these rules. One of these rules gives a transferee corporation a carryover basis (subject to certain adjustments) in the assets acquired from the transferor corporation. Sec. 362(b).[15] The other of these rules allows the transferee corporation to "succeed to and take into account" certain tax attributes of the transferor, including net operating loss carryovers (the tax attribute in issue in the instant case). Secs. 381(a), 381(c).[16]

Of the various definitions of corporate reorganization, the parties have apparently limited the controversy to whether the transaction qualifies as nondivisive D reorganization (sec. 368(a)(1)(D));[17] we have chosen in the instant case to adhere to

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[15] SEC. 362. BASIS TO CORPORATIONS.

(b) TRANSFERS TO CORPORATIONS.—If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the exchange of stock or securities of the transferee (or of a corporation which is in control of the transferee) as the consideration in whole or in part for the transfer.

[16] Secs. 381(a) and 381(c) provide, in relevant part, as follows:

SEC. 381. CARRYOVERS IN CERTAIN CORPORATE ACQUISITIONS.

(a) GENERAL RULE.—In the case of the acquisition of assets of a corporation by another corporation—

. . . . . .

(2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D) (but only if the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met), or (F) of section 368(a)(1),

the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsections (b) and (c).

. . . . . .

(c) ITEMS OF THE DISTRIBUTOR OR TRANSFEROR CORPORATION.—The items referred to in subsection (a) are:

(1) NET OPERATING LOSS CARRYOVERS.—The net operating loss carryovers determined under section 172, subject to * * * conditions and limitations * * *

[The subsequent amendment of sec. 381(a) (by sec. 4(g) of the Bankruptcy Tax Act of 1980, Pub. L. 96-589, 94 Stat. 3389, 3404 (1980)) does not affect the instant case.]

[17] SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) REORGANIZATION—

(1) IN GENERAL.—For purposes of parts I and II and this part, the term "reorganization" means—

. . . . . .

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of

the parties' view of the parameters of the controversy. See *Estate of Fusz v. Commissioner*, 46 T.C. 214, 215 n. 2 (1966).

In order to qualify as a nondivisive D reorganization[18] (and thus, permit petitioner to (1) use Studios' bases for calculating depreciation, and (2) under sections 368(a)(1)(D) and 354,[19] deduct Studios' net operating losses), the transaction in the instant case must satisfy a series of statutory requirements and also a series of judicial requirements.[20]

Respondent contends that the transfer from Studios to petitioner does not qualify as a nondivisive D reorganization because it does not satisfy certain of the statutory and judicial requirements. Instead, respondent contends, the transfer of assets from Studios to petitioner is a sale. Respondent maintains that the transaction does not satisfy the statutory requirement that stock of the transferee corporation (i.e., petitioner) be issued and distributed in the purported reorganization. Respondent also maintains that the transaction does not satisfy the judicial requirement of continuity of interest.

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the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356 * * *

[18]D reorganizations are commonly described as falling in either of two categories. One is called a divisive D reorganization—i.e., spinoff, splitoff, or splitup. The other category—the one which is at the center of the instant case—is called a nondivisive D reorganization. See Phillips, "Corporate Acquisitions—D Reorganizations," 417 Tax Mgmt. at A–1 (BNA 1981). A nondivisive D reorganization involves one corporation (the transferee) acquiring substantially all the assets of another corporation (the transferor), and then, after the transfer, the transferor being liquidated. Secs. 368(a)(1)(D) and 354.

[19]Sec. 354 provides, in relevant part, as follows:

SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) GENERAL RULE.—

(1) IN GENERAL.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * * * *

(b) EXCEPTION.—

(1) IN GENERAL.—Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368(a)(1)(D), unless—

(A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and

(B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

[The subsequent amendment of sec. 354(b)(1) (by sec. 4(h) of the Bankruptcy Tax Act of 1980, Pub. L. 96–589, 94 Stat. 3389, 3404 (1980)) does not affect the instant case.]

[20]"It remains true, therefore, that literal compliance with the reorganization provisions is not enough; a transaction will be governed by the statutory provisions only if it comes within their presuppositions as well as their language." Bittker & Eustice, *supra*, par. 14.03, at 14–11. See *Atlas Tool Co. v. Commissioner*, 70 T.C. 86, 100 (1978), affd. 614 F.2d 860 (3d Cir. 1980).

Specifically, respondent asserts that the continuity of interest requirement is not satisfied because either (1) "the preferred shareholder [Warsaw & Co., Inc.] had the proprietary interest in [Studios]" and did not continue an interest in petitioner, or (2) the minority shareholders who did continue an interest "had too small a proprietary interest in [Studios]."

Petitioner contends that the transaction between Studios and petitioner qualifies as a nondivisive D reorganization because it satisfies all the statutory and judicial requirements. In particular, petitioner contends that the 100 shares were given as consideration for Studios' assets and that the 100 shares were worth at least $42,727, far more than the $21,000 of cash and other property transferred by petitioner to Studios. Petitioner further contends that the fact that the 100 shares were issued directly to the 10 shareholders, rather than first to Studios and then distributed from Studios to the 10 shareholders, does not mean that petitioner's stock was not distributed within the meaning of section 354(b)(1)(B). Petitioner also asserts that the continuity of interest requirement is satisfied. In making this assertion, petitioner further contends that the proper test for applying the continuity of interest test is whether the stock of the transferee corporation (petitioner) represents a substantial part of the consideration given in the transaction and not whether a certain percentage of historic shareholders of the transferor continue as shareholders of the transferee.

We agree with respondent that the transaction is not a D reorganization because of the failure to satisfy the statutory requirement that petitioner's stock be transferred to Studios and distributed in a transaction which qualifies under sec. 354.

In order for a transaction to be a D reorganization, the transaction must be one "which qualifies under section 354." (Sec. 368(a)(1)(D); *Baan v. Commissioner*, 51 T.C. 1032, 1040 (1969), affd. sub nom. *Gordon v. Commissioner*, 424 F.2d 378 (2d Cir. 1970), affd. 450 F.2d 198 (9th Cir. 1971).) In order for petitioner to succeed to Studios' net operating losses under a D reorganization, Studios must have received stock of petitioner, and Studios must have distributed the stock it thus received (secs. 354(a)(1) and 354(b)(1)(B)). The July 2, 1973, agreement between petitioner and Studios provides (at 3(b)(1)) that, as part of the consideration flowing from petitioner to Studios,

"The Buyer is hereby issuing 10 shares of Common Stock, $.05 par value, of the Buyer to each of the shareholders of the Seller other than Warsaw & Co., Inc. who are the only shareholders of the Buyer." There was not literally a transfer of petitioner's stock from petitioner to Studios and a distribution of this stock by Studios to Studios' shareholders. Accordingly, we conclude that the statute's formal requirements have not been met in this regard.

It is true that "we have repeatedly held that, when the stock ownership of transferor and transferee is identical, the actual distribution would be a mere formality and the statute [sec. 368(a)(1)(D)] may be satisfied without it. See *American Manufacturing Co. v. Commissioner*, 55 T.C. 204, 221 (1970); *James Armour, Inc. v. Commissioner*, 43 T.C. 295, 307 (1964)." *Atlas Tool Co. v. Commissioner*, 70 T.C. 86, 97 (1978), affd. 614 F.2d 860, 865 (3d Cir. 1980). See also *Rose v. United States*, 640 F.2d 1030, 1034 (9th Cir. 1981). However, in the instant case, the stock ownerships of petitioner and Studios were not identical. Warsaw & Co., Inc., which owned about 80 percent of Studios' common stock and all of Studios' preferred stock, was not a shareholder in petitioner. The 10 shareholders, each holding 10 percent of petitioner's shares, had differing holdings in Studios. These holdings ranged from Zad's 375 shares down to Sinn's 92 shares. Indeed, apart from Shawn and Neil (each holding 250 shares), none of the 10 shareholders held the same number of Studios' shares as any of the others among the 10 shareholders (see table 1 and subsequent text, *supra*), even though all were equal shareholders in petitioner.

Thus, the instant case does not qualify for the one exception that the courts have created regarding the stock transfer and distribution rule. Compliance with this rule is essential for the net operating loss carryover benefit sought by petitioner (secs. 381(a)(2) and 354(b)(1)(B)) and the carryover basis benefit sought by petitioner (secs. 362(b), 368(a)(1)(D), 354(b)(1)(B)). Accordingly, we conclude that petitioner is entitled to use neither of the tax benefits it seeks to carry over from Studios.

On brief, petitioner makes the following contention regarding the stock transfer and distribution requirement:

> Code section 354(b)(1)(B) requires that all properties of the transferor corporation must be distributed in pursuance of the plan of reorganization. This provision is satisfied whenever, pursuant to the plan of reorganization,

the shareholders of the transferor receive shares of the transferee sufficient to satisfy the control requirements of Code section 368(a)(1)(D). A direct issuance of shares of the transferee corporation to shareholders of the transferor corporation will suffice. An actual exchange of the transferor corporation's assets for shares of the transferee corporation, followed by a distribution of those shares to the transferor corporation's shareholders is not required. *See Commissioner v. Morgan*, 288 F.2d 676 (3d Cir. [1961]), *cert. denied*, 368 U.S. 836 (1961). *Accord, South Texas Rice Warehouse Co.*, 43 T.C. 540 (1965), *aff'd sub nom, Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), * * *. *See also Retail Properties, Inc.*, 23 T.C.M. 1463 (1964) and Rev. Rul. 79-257, 1979-2 C.B. 136 * * *. Where as in the case at bar the acquiring corporation issues stock directly to the shareholders of the transferor corporation in consideration of the assets received from the transferor corporation, the transfer is treated as if the shares were first issued to the transferor corporation and then distributed in redemption of the outstanding shares of the transferor corporation.

We believe petitioner's reliance on the cases it cites is misplaced.

In *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir. 1961), the Court of Appeals for the Third Circuit reversed this Court (*Morgan v. Commissioner*, 33 T.C. 30 (1959)), holding that an actual transfer and distribution of the transferee corporation's stock "would have been a meaningless gesture" in that case, since one individual held all the stock in both the transferor corporation and the transferee corporation (288 F.2d at 680, see 33 T.C. at 32). In *South Texas Rice Warehouse Co. v. Commissioner*, 43 T.C. 540 (1965), we rejected the taxpayers' contention that a transaction did not qualify as a D reorganization because no stock was transferred and distributed. In that case, each of the 14 individuals who were the shareholders held the same percentage of the transferor corporation's stock as he or she held in the transferee corporation. (43 T.C. at 544.) The Court of Appeals for the Fifth Circuit noted the identity of ownership, followed the rationale of *Morgan*, and affirmed on this point. (*Davant v. Commissioner*, 366 F.2d 874, 886-887.) In *Retail Properties, Inc. v. Commissioner*, T.C. Memo. 1964-245, the transferee corporation was a wholly owned subsidiary of the transferor corporation. When the transferor liquidated, it distributed to its shareholders, pro rata (except for cash in lieu of fractional shares), the stock of its subsidiary, the transferee. In Rev. Rul 79-257, 1979-2 C.B. 136, respondent ruled that a distribution by a wholly owned subsidiary to its parent corporation may qualify as a partial liquidation under section

346(a)(2) (as in effect before the Tax Equity and Fiscal Responsibility Act of 1982), even though there is no redemption of stock.[21]

All of these authorities[22] on which petitioner relies are distinguishable from the instant case in that the transferors and transferees in those instances had identical ownership, while in the instant case, the ownership interests in petitioner and Studios differed widely. Further, in each of these cases in which a court has held that the requirement of an actual stock transfer and distribution may be ignored, it was respondent who urged on the court that the realities of the situation belied the form chosen by the taxpayer. In those situations where the courts have departed from the literal language of the statute, it was to counter a perceived abuse by the taxpayer, these courts having concluded that the taxpayer should not be permitted to shape the form of the transaction so as to secure an unwarranted benefit. See B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, par. 14.54, at 14–159—14–160. We have not found, and petitioner has not cited us to, any case in this area in which the court has acceded to a taxpayer's urging that the taxpayer be permitted to obtain a D reorganization tax benefit even though the form of the transaction which the taxpayer shaped did not meet the literal requirements of the statute.

Petitioner contends that the "transaction in form and in substance qualified as a reorganization described in Code section 368(a)(1)(D)". Petitioner states that the transaction and Studios' subsequent assignment for benefit of creditors were designed as a convenient way to shed a burdensome obligation (i.e., the 34th Street lease). Petitioner concludes as follows:

> Had [Studios] followed a formal redemption/Chapter XI format, the reorganized corporation unquestionably could have carried over and utilized its pre-Chapter XI reorganization net operating losses. A different result should not obtain where the parties, on the advice of their respective counsel, achieved the same substantive results utilizing a (D) reorganization format.

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[21] In Rev. Rul. 81–3, 1981–1 C.B. 125, respondent ruled that a pro rata distribution by a corporation to its shareholders may also qualify as a partial liquidation even if there is no actual surrender of stock.

[22] As to the precedential value of Memorandum Opinions and Revenue Rulings, see, e.g., *Newman v. Commissioner*, 68 T.C. 494, 502 n. 4 (1977), and *Estate of Smead v. Commissioner*, 78 T.C. 43, 47 n. 5 (1982), respectively.

We have already concluded that the transaction failed to satisfy one of the formal statutory requirements of section 368(a)(1)(D). As to the substance, we note that the parties to the transaction chose to create a new corporation rather than continue the old one; we are not persuaded that they should have the tax benefits they seek merely because they could have achieved the same business purposes by a different route that would have continued the old corporation and thereby provided these benefits.[23]

When we examine the substance of what was done, we conclude that it points toward "sale" at least as much as toward "reorganization". Ten people put up an aggregate of $100,000 to acquire and bankroll a going business. The business had suffered substantial losses. The 10 shareholders trimmed the work force and avoided the burdens of an unfavorable lease, and apparently succeeded in reviving the business. The 10 shareholders had owned about 20 percent of the old corporation's common stock and none of its preferred. If they had purchased the remaining common stock or a controlling interest, then (as petitioner notes on brief) the corporation's tax characteristics would not be affected by the substance of the change in ownership and control. Apparently, for a legitimate business reason (escaping from the burdens of the 34th Street lease), the 10 shareholders specifically turned down an opportunity to buy the old corporation, thus turning down the simple route toward retention of the old corporation's tax attributes.

If the 10 shareholders (or petitioner, their new corporation) had merely purchased Studios' assets, then the transaction would be a sale, the normal tax rules would apply (i.e., petitioner would not be entitled to use Studios' tax attributes) even though petitioner carried on the business that Studios had carried on and did so with essentially the same work force at the "same old stand."

What, in these circumstances, is the matter of substance that distinguishes the transaction from a sale? Petitioner

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[23] "Petitioners are liable for the tax consequences of the transaction that they actually executed; they may not reap the benefits of some other transaction that they might have effected instead. *Don E. Williams Co. v. Commissioner*, 429 U.S. 569, 579 * * * (1977); *Commissioner v. Nat'l. Alfalfa Dehydrating*, 417 U.S. 134, 149 * * * (1974)." *Brown v. Commissioner*, 706 F.2d 755, 756 (6th Cir. 1983), affg. T.C. Memo. 1981-608.

contends that the issuance of the 100 shares is an element of substance that (1) enables the transaction to satisfy the statutory requirement of stock distribution, (2) enables the transaction to satisfy the judicial requirement that its stock be a substantial part of the consideration given by it, and (3) as an alternative, enables petitioner to substantially increase its basis in the assets received from Studios. In connection with the latter two points, petitioner contends that the 100 shares were worth $349,000.[24]

After examining the transaction with care in light of petitioner's contentions, we note the following:

Firstly, the 100 shares effected no change, not even a subtle one, in the positions of the 10 shareholders. Each of the 10 shareholders merely had one extra piece of paper. See *Eisner v. Macomber*, 252 U.S. 189 (1920). None involved in the transaction—not petitioner, Studios, the 10 shareholders, Warsaw & Co., Inc., or J.J. Warsaw—were any richer or any poorer on account of the issuance of the 100 shares, than they would have been if no shares were issued or if 1 million shares were issued.

Secondly, care was taken to be sure that the 100 shares were not held by Studios at any time. This element is of some significance because Studios made a general assignment for the benefit of creditors only 3 weeks after the transaction in dispute, and the assignee was not able to find assets to make any payments to the creditors.

Thirdly, although the 100 shares were supposed to be issued to the 10 shareholders in their capacities as Studios' shareholders, they were issued (see note 13 *supra*) in proportion to the 10 shareholders' ownership of petitioner and not in proportion to the 10 shareholders' ownership of Studios.

Fourthly, petitioner contends that the 100 shares were worth a total of $349,000, while at the same time the initial 1,000 shares were worth a total of $100,000. The contentions, as to identical shares issued virtually simultaneously, are

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[24] "On opening brief (pp. 23-24), petitioner states that after "the transfer the value of the shareholders' equity in [petitioner] increased from $100,000 to $449,000 ($100,000 + $370,000 – $21,000). Thus the shares 'issued' in the transaction represented 77.7% (349/449) of [petitioner's] value." The $349,000 value is also contended for on page 40 of petitioner's opening brief, and implicitly on page 58 of petitioner's opening brief.

However, on other pages of petitioner's opening brief, petitioner contends for values of "not less than $42,727" (p. 39) and $80,000 (p. 40).

manifestly inconsistent. We are not given any hint as to why the 100 shares would be worth $3,490, each, while the 1,000 shares were worth $100, each.

On answering brief, petitioner tells us that "Taxation is a practical art; labels will not replace or substitute for judgment as to the roles played by the parties and whether or not those roles were acted out in such a way as to effect a reorganization described by the Internal Revenue Code". We agree. We conclude that, as a practical matter, the appearance of the 100 shares in the transaction provides only a smell of reorganization. We will not speculate as to why the July 2, 1973, agreement provided for the issuance of the 100 shares in such a manner that their issuance satisfies neither the form nor the substance of section 368(a)(1)(D). We conclude that the 100 shares did not constitute any part of petitioner's consideration for the assets, tangible or intangible, that petitioner received from Studios. Finally, petitioner contends as follows:

> Respondent implies that each of the exhibits is to be viewed as evidence, not only as to the existence of the document but also as to the truth of each statement made in the document. If respondent is correct, then those documents establish petitioner's contention that 100 shares of [petitioner's] stock was paid by [petitioner] to [Studios] in partial consideration for the transfer of the [Studios] assets to [petitioner] [Exhibit 6-F].

Petitioner overlooks the fact that neither party requested that the exhibits to which petitioner's contention relates be received only for limited purposes (see rule 105, Fed. R. Evid.), and the Court did not limit the purposes for which this evidence was received. Accordingly, the exhibits may be used as evidence of the truth of the matters stated therein. It does not follow from this that the mere fact that a statement appears in an exhibit is necessarily enough to *establish* the truth of the statement. We may accept Homer's "Iliad" as evidence that there was a Troy and that the Trojan War took place, without thereby being required to agree to the truth of Homer's statements about the roles of Eris and the other members of the Greek pantheon in the creation and prosecution of the war.

For reasons we have set forth *supra*, we do not believe that the statement that petitioner refers to in Exhibit 6-F establishes that there has been compliance (either in form or in

substance) with the stock transfer and distribution requirements for a D reorganization.

To sum up: petitioner is not entitled to use Studios' bases for depreciation of assets and is not entitled to deduct Studios' net operating losses unless petitioner shows that it has complied with the requirements of a D reorganization. *Baan v. Commissioner, supra.* See also *Corn Products Co. v. Commissioner*, 350 U.S. 46, 52 (1955), where, in another context, the Supreme Court stated that "an exception from the normal tax requirements of the Internal Revenue Code, * * * must be narrowly applied and its exclusions interpreted broadly." Petitioner acknowledges that the transaction failed to comply with one of the requirements of the statute, but seeks to excuse this failure by citing certain authorities. Those authorities rest on circumstances (identical ownership of the corporations that are parties to the reorganization) which are materially different from the facts of the instant case. *Atlas Tool Co. v. Commissioner, supra; Baan v. Commissioner*, 51 T.C. at 1038–1039. There was no substance to the issuance of the 100 shares. Petitioner cannot escape from the failure of the transaction to comply with the statute. Petitioner is not entitled to the tax benefits of another corporation's bases and net operating losses.

We hold for respondent on this issue.[25]

II. The 100 Shares

Petitioner contends that, if we hold for respondent on the reorganization issue, then petitioner's bases for depreciation of the assets acquired from Studios should be increased by the fair market value of the 100 shares issued by petitioner (see note 24 *supra*), to a total of $150,000; also the base for the investment credit should be correspondingly increased. (Petitioner notes the statute then in effect imposed a $50,000 statutory ceiling on investment in used section 38 property.) Petitioner relies on sections 167(g), 1011, 1012, and 1016(a), arguing that the 100 shares were issued in exchange for Studios' assets.

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[25] Since we hold that petitioner failed to vault the statutory hurdle of stock transfer and distribution, it is not necessary to determine whether petitioner succeeded in vaulting the judicial hurdle of continuity of interest.

Respondent's primary position is that no additional basis is attributable to the 100 shares because they were not issued in exchange for the assets transferred from Studios but rather were either (1) in exchange for the 10 shareholders' original capital investment in petitioner or (2) a stock dividend. Alternatively, respondent asserts that the "100 shares were worth no more than and probably less than, $9,091 (1/11 of the $100,000 capital)."

We agree with respondent's primary position.

We have found that the 100 shares did not constitute part of the consideration paid by petitioner to Studios in exchange for substantially all of Studios' assets. We have elaborated on this matter in our discussion of the D reorganization issue, *supra*, and see no need to repeat our analysis at this point. We have not found any substance to the issuance of the 100 shares. (See note 13 *supra*.)

We hold for respondent on this issue.

III. Legal Expenses

Of the $4,342 paid for legal expenses, the deductibility of which is in issue, the parties agree that $942 was paid for organizational expenses of petitioner. The parties disagree as to whether petitioner made a proper election to amortize this amount under section 248.[26]

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[26] "SEC. 248. ORGANIZATIONAL EXPENDITURES.

(a) ELECTION TO AMORTIZE.—The organizational expenditures of a corporation may, at the election of the corporation (made in accordance with regulations prescribed by the Secretary or his delegate), be treated as deferred expenses. In computing taxable income, such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the corporation (beginning with the month in which the corporation begins business).

(b) ORGANIZATIONAL EXPENDITURES DEFINED.—The term "organizational expenditures" means any expenditure which—

(1) is incident to the creation of the corporation;

(2) is chargeable to capital account; and

(3) is of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life.

(c) TIME FOR AND SCOPE OF ELECTION.—The election provided by subsection (a) may be made for any taxable year beginning after December 31, 1953, but only if made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof). The period so elected shall be adhered to in computing the taxable income of the corporation for the taxable year for which the election is made and all subsequent taxable years. The election shall apply only with respect to expenditures paid or incurred on or after the date of enactment of this title.

[The subsequent amendments of this provision by secs. 1901(a)(36) and 1906(b)(13) [sic] (A) of the Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1520, 1770, 1834, do not affect the instant case.]

Respondent contends that, in order to amortize the expenses under section 248, petitioner must make a timely election, as provided for under section 248(c) and section 1.248–1(c), Income Tax Regs. Respondent asserts that petitioner did not make such a timely election and thus, none of these expenses are deductible. Petitioner concedes that it erred in deducting the full $942 in its fiscal year 1974; however, petitioner contends that it may amortize these expenses under section 248 because "by claiming its $942 of organizational expenses as a deductible expense in the year of its organization * * * [it] manifested its decision to be bound by [the section 248] election."

As to the remaining $3,400 of legal expenses, respondent contends that (1) if we hold for respondent that there was no reorganization, then the $3,400 is to be added to the bases of the assets petitioner acquired from Studios and deducted by way of depreciation;[37] (2) alternatively, if we hold for petitioner that the transactions with Studios amounted to a D reorganization, then the $3,400 is an organizational expense to which section 248 applies and no deduction is allowable because petitioner failed to make an election under section 248. Petitioner contends that these expenses are not organizational expenses and thus, their deductibility is not controlled by section 248. Rather, petitioner contends, the amount must be apportioned among the following categories of assets it acquired from Studios: depreciable assets ($1,378.38, deducted by way of depreciation over these assets' stipulated 10–year useful life), going-concern value, and goodwill ($1,378.38, not deductible currently and not deductible by way of depreciation or amortization), and work in progress ($643.24, deductible in full currently).

As to the $942, we agree with respondent. As to the $3,400, we agree with respondent's first contention.

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[37] At trial, respondent contended that the $3,400 was incurred incident to Studios' formation, and that no deduction is allowable with respect to this amount because petitioner failed to elect amortization under sec. 248. As noted in the text, on brief respondent has modified this position, at least if we hold that there was no reorganization. On answering brief, respondent also concedes that, if the $3,400 is to be added to petitioner's bases in the depreciable assets, then the $3,400 also is to be taken into account in computing petitioner's investment credit on account of its purchase of these assets. Correspondingly, petitioner concedes that, if we hold for it on the reorganization question, then no investment credit would be allowable on account of its acquisition of assets from Studios.

A. $942

Section 248(a) affords a newly created corporation an opportunity to elect to amortize certain expenses over a period of time (not less than 60 months) chosen by the corporation. As petitioner acknowledges, but for this election, such expenditures are not deductible until the corporation is terminated. E.g., *McCrory Corp. v. United States*, 651 F.2d 828, 832–833 (2d Cir. 1981); *Malta Temple Association v. Commissioner*, 16 B.T.A. 409 (1929).

Section 248(a) provides that the election must be "made in accordance with regulations prescribed by the Secretary or his delegate". Under this statutory authority, respondent prescribed the following in section 1.248–1(c), Income Tax Regs.:

> (c) *Time and manner of making election.* The election provided by section 248(a) and paragraph (a) of this section shall be made in a statement attached to the taxpayer's return for the taxable year in which it begins business. * * * The statement shall set forth the description and amount of the expenditures involved, the date such expenditures were incurred, the month in which the corporation began business, and the number of months (not less than 60 and beginning with the month in which the taxpayer began business) over which such expenditures are to be deducted ratably.

No statement of the sort required by the regulation was attached to petitioner's tax "return for the taxable year in which it [began] business." None of the required information was noted on the tax return in connection with petitioner's deduction of the $942. Petitioner did not attempt, on its tax return, to select an amortization period of not less than 60 months for deducting the $942; rather, petitioner deducted the entire amount on its first tax return. Petitioner's deduction was inconsistent with any election that it might validly have made under section 248.

We conclude that petitioner failed to make an election under section 248. From petitioner's deduction, we conclude that petitioner did not intend to make an election under section 248. Nothing in the record or legal setting of the instant case makes it appropriate to consider the question of "substantial compliance" with the regulation. Cf. *Tipps v. Commissioner*, 74 T.C. 458 (1980). Under these circumstances, no deduction is allowed on account of the $942 organizational expense item in the years in issue.

We hold for respondent on this issue.

B. $3,400

The $3,400 was paid and incurred by petitioner in connection with the transactions whereby petitioner succeeded to essentially the business conducted by Studios and the assets used by Studios. Although we agree with petitioner that the $3,400 ought to be apportioned among the assets, tangible and intangible, that it received from Studios, the inadequacy of the record hampers us in making determinations of value, or even relative value.

Petitioner asserts that the work in progress was worth $70,000, and that we should take this value into account in allocating the $3,400. However, on brief petitioner also asserts (and we have found) that the work in progress "was of no value to [Studios] in its then uncompleted state." Petitioner received Studios' work in progress; in exchange, petitioner agreed to complete the work and to assume Studios' liabilities to customers in connection with the work. We have no reason to believe that the work in progress had a fair market value in excess of zero.

Petitioner asserts that Studios' goodwill and going-concern value was worth $150,000. No persuasive evidence was presented as to this value. Respondent contends that the "only asset [petitioner] received that had any value was the equipment". Respondent's position as to the goodwill and going-concern value results in greater amounts of deductions for depreciation, and a greater amount of investment credit, than petitioner's position.

We conclude that petitioner has failed to show that it is entitled to greater amounts of depreciation deductions on account of the $3,400 than those resulting from respondent's determination. We conclude that petitioner has failed to show that it is entitled to a greater amount of investment credit than that resulting from respondent's concession. (See note 27 *supra*.)

We hold, for respondent, that the $3,400 is to be added to the bases of the 10-year-useful-life assets that petitioner acquired from Studios.

IV. Covenant Not To Compete

Petitioner contends that amounts paid by it under a covenant not to compete should be deductible over the number of months the payments were made—i.e., 31 months—because (1) the covenant was enforceable only over that period of time, and (2) such deductions would be consistent with petitioner's cash method of accounting.

Respondent maintains that the amounts are deductible ratably over the life of the covenant, which respondent asserts is 6 years, the stated term of the covenant. Respondent urges the Court to give no weight to Shawn's testimony on the unenforceability under State law of the covenant after 31 months.

We agree with respondent.

The price of a covenant not to compete is amortizable ratably over the life of the covenant. *United Finance & Thrift Corp. of Tulsa v. Commissioner*, 31 T.C. 278, 285–286 (1958), affd. 282 F.2d 919 (4th Cir. 1960).

In the instant case, the covenant states a term of 6 years. In order to persuade us that we should disregard the stated term and instead accept the period over which the payments were made (31 months), petitioner must present us with at least strong proof that the covenant not to compete was not intended to be for 6 years and was intended to be only for 31 months. See, e.g., *Ullman v. Commissioner*, 264 F.2d 305, 308 (2d Cir. 1959), affg. 29 T.C. 129 (1957); *Ledoux v. Commissioner*, 77 T.C. 293, 308 (1981), affd. 695 F.2d 1320 (11th Cir. 1983); *Miami Purchasing Service Corp. v. Commissioner*, 76 T.C. 818, 830 (1981); *Major v. Commissioner*, 76 T.C. 239, 247 (1981).

Petitioner tries to persuade us by asserting that the covenant not to compete would not be enforceable for 6 years. Petitioner cites but one case in support of its proposition that the covenant was enforceable under New York law for only the 31-month payout period. In the one cited case, *Purchasing Associates, Inc. v. Weitz*, 13 N.Y.2d 267, 246 N.Y.S.2d 600 (1963), the Court of Appeals of New York refused to enforce a covenant by an employee that, for 2 years after the termination of his employment, he would not work for a competitor within a 300-mile radius of New York City. By a 4 to 3 vote, the Court of Appeals held that the covenant should be tested by

the restrictive rules applicable to employment contracts and not the more lenient rules applicable to sales contracts. The three dissenters would have applied the sales contract rules and, agreeing with the courts below, would have enforced the covenant.

More recently, in *Karpinski v. Ingrasci*, 28 N.Y.2d 45, 320 N.Y.S.2d 1, 363 N.E.2d 573 (1971), the Court of Appeals of New York upheld an employment covenant not to compete with the employer in the employer's line of business in a five-county area for an unlimited term. In *Gelder Medical Group v. Webber*, 41 N.Y.2d 680, 394 N.Y.S.2d 867 (1977), the Court of Appeals of New York upheld a covenant by a former partner not to compete with his former partnership within a 30-mile radius of a village for a 5-year term.

We are not persuaded that the Courts of New York State would refuse to enforce the covenant in the instant case. We conclude that petitioner has not adduced strong proof, and thus has failed to persuade us that the 6-year term is not the intended life of the covenant not to compete. We further conclude that the life of the covenant is 6 years and that the price of the covenant, $31,000, is amortizable over this period.[28]

We hold for respondent on this issue.

In order to reflect the foregoing and the parties' settlement of other issues,

Decision will be entered under Rule 155.

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[28] Petitioner's proposed findings of fact set the transaction, and presumably the start of the covenant's term, as April 1974. This is consistent with the three monthly payments made in petitioner's taxable year 1974 (ending June 30). Respondent allows a deduction in petitioner's taxable year 1974 for one-twelfth of the total covenant payments, implying a January 1974 start of the covenant's term. This is consistent with the Dec. 20, 1973, date of petitioner's agreement with Color Masters and the "1/2/74" date shown on petitioner's income tax return as the date of petitioner's acquisition of Color Masters' stock. The parties do not favor us with an explanation of this discrepancy. Since respondent's position apparently is more favorable to petitioner than is petitioner's position, on this point, we leave the parties as we find them and allow petitioner to deduct $2,583 for petitioner's fiscal year 1974, implying a Jan. 1, 1974, start of the covenant's term.

JAMES E. FOY AND NANCY L. FOY, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

EXPANSION ENTERPRISES, INC., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 10976–81, 10977–81. Filed January 14, 1985.

Petitioners sold their contract rights in a janitorial and building maintenance franchise network and reported the proceeds of the sale under the installment method of accounting. *Held*, petitioners sold capital assets which are entitled to capital gain treatment. *Held, further*, the proceeds properly were reported under the installment method.

Clifford N. Ribner, for the petitioners.
Juandell D. Glass, for the respondent.

SWIFT, *Judge*: Respondent determined deficiencies in petitioners James and Nancy Foy's Federal income tax liabilities for the years 1976 and 1977, in the amounts of $2,095 and $3,683, respectively, and in petitioner Expansion Enterprises' Federal income tax liabilities for the years 1975 and 1976, in the amounts of $12,288.29 and $70,822.74, respectively. Respondent also included in the notice of deficiency to petitioner Expansion Enterprises for the year 1975, an addition to tax pursuant to section 6651(a)(1)[1] in the amount of $3,072.07.

The parties have reached a partial settlement, and the three remaining issues for the Court to decide are: (1) Whether proceeds received by petitioners from the sale of certain contract rights are taxable as ordinary income or as capital gain; (2) whether the proceeds are reportable under the installment method; and (3) whether petitioner Expansion Enterprises is subject to an addition to tax under section 6651(a)(1). An order consolidating these cases was issued by the Court on December 6, 1982. These consolidated cases were submitted fully stipulated pursuant to Rule 122. The stipulated facts are incorporated herein by this reference.

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[1] All section references are to the Internal Revenue Code of 1954 as amended and in effect during the taxable years at issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Petitioners James and Nancy Foy resided in Coweta, Oklahoma, at the time their petition herein was filed. They timely filed their 1976 and 1977 Federal income tax returns.

Petitioner Expansion Enterprises, Inc., a California corporation, maintained its principal place of business in Tulsa, Oklahoma, at the time its petition herein was filed. Expansion Enterprises filed its Federal corporate income tax return for its taxable year ending September 30, 1975, on or about July 13, 1976, and timely filed its Federal corporate income tax return for its taxable year ending September 30, 1976.

The issues herein arise out of the growth and development of a janitorial and building maintenance business which began in the 1960's in Southern California and which expanded throughout the United States in the early 1970's. Most of the business expansion and growth occurred in the form of franchises, and the primary issue herein concerns the rights, responsibilities, and interests of petitioners in the franchise network and the manner by which they should be taxed on their transfer in 1976 of their contract rights in the franchise network.

Specific information with regard to the financial success or failure of the various Environment Control franchises, their share of the local janitorial market in the various cities, the quality of their management, and the extent of the goodwill that may have been developed by the franchisors or by the franchisees is not in the record. The necessary facts, however, which are critical to a determination of the taxation of petitioners on the sale of their interests in the franchise network are found in the record and for the most part are reflected in a series of contractual agreements entered into between 1969 and 1976, which agreements established the rights and responsibilities with respect to the franchise network of petitioner James Foy (hereinafter referred to as Foy), of an individual named Daryl Kraft (hereinafter referred to as Kraft), of petitioner Expansion Enterprises (Foy's wholly owned corporation), and of Environment Control Building Maintenance Co. (Kraft's wholly owned corporation).

We will begin our discussion of the facts with a brief description of the background of the janitorial business and of the early business relationship between the founding individu-

als. Unfortunately, the written agreements between the individuals were poorly drafted, and the stipulated facts leave many aspects of the business unclear.

Foy attended Biola College in Los Angeles, California. After graduation in the late 1950's or early 1960's, he spent 4 years as a youth pastor in Santa Ana, California. Foy then began selling insurance and continued to do so exclusively for approximately 4 years. One of his insurance clients was Kraft.

Kraft also attended Biola College and became friends with Foy. During Kraft's college days at Biola and after graduating, he worked for a company that provided janitorial and building maintenance services in Southern California. He eventually became one of the company's three partners.

Some time around 1963, Kraft formed three partnerships to provide janitorial services for commercial businesses. The partnerships formed by Kraft operated under the name of ADA Building Maintenance Co. One of the partnerships was formed with Ken McCray (hereinafter referred to as McCray) to provide janitorial services in Fresno, California. Another partnership was formed with John Theissen to provide janitorial services in Los Angeles, California. A third partnership was formed with Jerry Kraft, who was a cousin of Kraft, apparently to provide janitorial services in Portland, Oregon. Kraft was responsible for the business administration of each of the businesses operated by the partnerships, and the other partner in each partnership was responsible for supervising employees and for negotiating contracts with building agents and managers for the performance of janitorial services by the partnerships.

In early 1969, Kraft formed yet another partnership to provide janitorial services in Santa Ana, California. His partner in this business was petitioner James Foy. Foy initially intended to work part time for that partnership, and he hoped that many of his insurance clients and contacts in Santa Ana would be a source of business for the new partnership. Foy did not like the name used for the prior partnerships formed by Kraft (namely, ADA Building Maintenance Co.), and Foy suggested and Kraft agreed that the name "Environment Control" be used for the new partnership. Both Kraft and Foy had equal 50-percent interests in that first Environment Control partnership. Similar to the division of

responsibilities in the earlier partnerships, Kraft was responsible for the business administration, and Foy was responsible for finding and negotiating contracts with potential customers. Foy's brother also worked for this partnership and supervised the janitorial work on the job sites.

In the middle of 1969, Kraft and Foy formed another partnership to provide janitorial services in Santa Barbara, California. That partnership also used the name "Environment Control," and Kraft and Foy had equal 50-percent interests therein. Again, Kraft was responsible for business administration, and Foy was responsible for finding and negotiating contracts with potential customers. In that regard, Foy spent 1 day a week in Santa Barbara meeting with potential customers and negotiating contracts. Later, the manager of the Santa Barbara partnership was given a 15-percent interest in the partnership, and Kraft's and Foy's interests were reduced to 42.5 percent each.

In late 1969, Kraft and Foy decided to expand their janitorial business to various cities throughout the United States by selling Environment Control franchises to local individuals or partnerships in the various cities. The Environment Control franchise network grew rapidly between the early 1970's and 1976 and spread to many cities throughout the United States and Canada, including Baltimore, Orlando, Cincinnati, and Toronto, to name just a few.

Environment Control Building Maintenance Co., Inc. (hereinafter referred to as ECI), was formed by Kraft in August of 1970, apparently to act as the named franchisor on the franchise agreements and to be responsible for the training and administrative responsibilities for which Kraft in his individual capacity previously had been responsible. Kraft was the sole shareholder and president of ECI, and it was by Kraft, as officer of ECI, that those administrative responsibilities were to be performed after ECI was organized. Foy was vice president of ECI. It is unclear whether Kraft received a salary from ECI during the years 1970 through 1976. Foy, however, did not receive a salary from ECI at any time.

Expansion Enterprises, Inc. (hereinafter referred to as Expansion), was formed by Foy prior to November of 1971, in order to assume many of Foy's rights, duties, and responsibilities with regard to the franchise network. Foy, however, was

the sole shareholder and president of Expansion, and it was by Foy, as officer of Expansion, that those duties and responsibilities were to be performed. Kraft was vice president and Foy's wife, Nancy, was secretary. The record does not indicate whether Foy, Kraft, or Foy's wife received a salary from Expansion.

A number of franchise agreements entered into by local franchisees doing business as part of the Environment Control franchise network, and the various agreements entered into between Foy, Kraft, ECI, and Expansion have been stipulated to. Under the local franchise agreements, the franchisee paid an initial franchise fee ranging from $5,000 to $25,000 to acquire the exclusive right to operate an Environment Control janitorial business within a designated geographic area. Generally, the geographic area covered by one franchise agreement was one city or metropolitan area. The agreements stated that the franchisee was an independent contractor and was neither in a partnership with, nor in a joint venture with, the franchisor.

The franchise agreements required the franchisor or its agents to negotiate contracts with building agents and managers under which the local franchisee would be entitled to perform janitorial services in return for a fee. Under the agreement, the franchisor also was obligated to negotiate a sufficient number of contracts, on behalf of the franchisee, with local customers so that within 18 months of the start of a local franchise, the franchisee would have received a specified level of fees for janitorial services rendered. That obligation of the franchisor will be referred to hereinafter as the "sales guarantee."

If the fees of the local franchise from janitorial services failed to meet the specified guaranteed amount, the franchisee would have the following three options: (1) Full refund of the initial franchise fee and relinquishment of the franchise; (2) partial refund of the franchise fee computed in accordance with the portion of the sales guarantee not satisfied; or (3) placement by the franchisor at the franchisor's expense of a salesman in the local franchisee's territory until the sales guarantee was satisfied. The franchisor also agreed periodically to inspect the local franchise operations.

The franchisee was entitled to retain 5 percent of gross sales[2] as compensation for janitorial services rendered. The franchisee also was entitled to retain 50 percent of the first $6,000 of net profits[3] during each calendar quarter and 75 percent of net profits in excess of the first $6,000. The franchisor, therefore, had a right to receive 50 percent of the first $6,000 of net profits, and 25 percent of net profits in excess of the first $6,000.

From the various documents, it is not completely clear who the franchisor was. Based upon the limited number of franchise agreements submitted by the parties, it appears that Kraft, in his individual capacity, signed the franchise agreements which were entered into prior to the end of 1971. We know, however, from the stipulation of facts and from agreements yet to be described that, from 1969 until the end of 1971, Kraft was in equal partnership with Foy and/or McCray as franchisor and that, with respect to some local franchises, other individuals also were in partnership with Kraft, Foy, and McCray as franchisor. However, the 1970 and 1971 franchise agreements do not acknowledge the other members of the partnership (namely, Foy and/or McCray), nor do they acknowledge Kraft's representative capacity in signing the franchise agreements on behalf of the other individuals.

Similarly, the three franchise agreements in evidence, which were signed after November of 1971, reflect simply the signature of ECI (Kraft's wholly owned corporation) as franchisor. The agreements themselves do not acknowledge that Foy and other individuals or entities may have been in partnership with or in a joint venture with Kraft and/or ECI.

We now turn to an analysis of the terms of each of the agreements entered into between Kraft, Foy, and their respective wholly owned corporations with respect to the Environment Control franchise network. It is important that we start with the first agreement between Kraft and Foy and understand the initial relationship between the individuals and then

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[2]Gross sales were defined in the franchise agreements as the amount of all fees for franchise services less sales tax and less the amounts of any actual refunds, overcharges, and allowances.

[3]Net profits were defined in the franchise agreements as sales actually received resulting from operations of the franchise after payment of all expenses and liabilities. In the earlier franchise agreements in 1970 and part of 1971, the franchisee was entitled to retain 50 percent of the first $2,000 dollars of net profits, and 75 percent of net profits in excess of $2,000.

note changes or lack of changes in that relationship as reflected in subsequent agreements.

The first agreement between Kraft and Foy was entered into on October 14, 1969. Foy purchased from Kraft for $500 the exclusive right to establish and promote local Environment Control franchises in Southern California. At the same time, McCray purchased from Kraft for $500, the exclusive right to establish and promote local Environment Control franchises in Northern California. Under the October 14, 1969, agreement, the division (as between Kraft, Foy, and McCray on one hand and the local franchise operators on the other) of the initial franchise fees, profits, and "ownership" of the local franchises to be established in Southern and Northern California was to be as follows:

SOUTHERN CALIFORNIA FRANCHISES

	Profits[4]	*Franchise fees*	*Ownership*
Kraft	25%	75%	25%
Foy	25	25	25
Local franchise operators	50	---	50
Total	100	100	100

NORTHERN CALIFORNIA FRANCHISES

	Profits	*Franchise fees*	*Ownership*
Kraft	25%	75%	25%
McCray	25	25	25
Local franchise operators	50	---	50
Total	100	100	100

The October 14, 1969, agreement also provided that with respect to the nationwide franchise network which the participants in the agreement then contemplated, Kraft would be responsible for the business administration of all existing and new janitorial businesses operating under the Environment Control name, including bookkeeping and secretarial services, and the preparation of all legal documents necessary to establish the various local businesses. Foy and McCray would be responsible for the sales and promotion of Environment

[4]Profits percentages are derived from the ownership percentages.

Control businesses throughout the United States. They could either set themselves up as the local franchisees in the various locations or they could assist others to establish local Environment Control franchises. Foy and McCray were required to pay Kraft $500 for each State in which either of them actually exercised the right to become the exclusive salesman and promoter of Environment Control in a particular State. If neither Foy nor McCray exercised his exclusive rights to the promotion of Environment Control in a particular State, Kraft could then purchase such rights before they were offered for sale to some other individual. In that situation, it is not clear to whom Kraft would have paid the $500.

The individual who obtained exclusive rights to the promotion of Environment Control within a State or "franchise area" was responsible to start or to have started at least one Environment Control business within that State or area and to obtain a sufficient number of accounts so that each Environment Control local franchise within a State or area would generate at least $5,000 of receipts over the first 15 months of operation.

The individual who held the exclusive promotion rights with respect to Environment Control in a State or area also received a 25-percent "permanent ownership" interest in all Environment Control companies established within that franchise area. While not completely clear, the 25-percent "ownership" interest entitled the exclusive promoter (typically Foy or McCray), among other things, to 25 percent of all "profits" of each local franchise located within the promoter's particular State or area. It is not specified what percentage of the profits, if any, of each local franchise Kraft was to receive.

The October 14, 1969, agreement also provided that some type of unfunded retirement program would be established for Kraft, Foy, and McCray. Monthly retirement checks were to be based on a percentage of gross receipts of each local business that had been established within each individual's exclusive areas prior to retirement.

Additionally, under the October 14, 1969, agreement, Foy and McCray each, individually, had the "first right of refusal" with respect to any new franchisee. This apparently amounted to a right to veto any new proposed franchisee, whether or not

the new franchise was to be located in one of Foy's or McCray's respective States or territories.

The next agreement was entered into on January 8, 1970, between Kraft, Foy, and McCray, and purported to supersede the October 14, 1969, agreement. Under that agreement, Kraft, Foy, and McCray were to administer the nationwide Environment Control franchises through a corporation to be named Environment Control, Inc. Kraft, Foy, and McCray were to be stockholders of that corporation and were each to be required to sign all franchise agreements. The intended percentages of stock to be owned by each individual were not specified. However, the profits and fees received by the corporation and the "excess funds" of the corporation to be formed were to be shared as follows:

	Profits	*Franchise fees*	*Excess funds*[5]
Kraft	50%	40%	- - -
Foy	25	30	50%
McCray	25	30	50
Total	100	100	100

Their status as stockholders and their shares of profits, franchise fees, and excess funds, as indicated above, strongly suggest that Foy and McCray were to each hold a 25-percent equity interest in the corporation to be formed.

With respect to three specific local franchises in San Bernardino, Riverside, and Irvine, California, Foy was to receive 100 percent of the profits and fees received from local franchises in return for assisting the local franchises to reach the minimum $5,000 level of receipts for the first 15 months of business. That same modification of the typical split of profits and fees was made for McCray with respect to the San Jose, Visalia, and Oakland, California, local franchises.

Each of the three individuals was to have certain rights and responsibilities under the January 8, 1970, agreement. Kraft was to be in charge of the nationwide administration of all Environment Control businesses. Foy was to continue to search for new franchisees and to locate and negotiate new

[5] All "excess funds" were to be credited to the "Expense Account" and were to be split equally between Foy and McCray.

accounts for the franchises throughout the country. McCray was obligated to assist local franchises started after January 8, 1970, to meet their guaranteed sales levels. All three individuals continued to have the right to veto any new franchisee and were required to sign any agreement entered into with each new franchisee. All "commitments" made to additional sales representatives of Environment Control were solely the responsibility of Foy and McCray and were to be paid out of their respective profits or expense account funds.

The corporation proposed in the January 8, 1970, agreement was never incorporated. Apparently, in partial place thereof, in August of 1970 Kraft formed ECI, his wholly owned corporation.

On March 14, 1972, another written agreement was entered into between Foy, Kraft, and ECI, ECI being the successor in interest to Kraft, in order to ratify certain oral agreements entered into between Foy and Kraft. No explanation was offered as to why McCray was not a party to the March 14, 1972, agreement. That agreement specifically excluded from any of its provisions the rights and responsibilities of Kraft and Foy with respect to the Environment Control franchises located in Santa Ana, Santa Barbara, Fresno, San Gabriel, and Whittier, California, and in Portland, Oregon. Presumably, the rights and responsibilities of Kraft and Foy with respect to those franchises remained governed by the January 8, 1970, agreement.

Many of the provisions of the March 14, 1972, agreement were similar to the provisions of the earlier agreements. There were, however, significant differences. With regard to the split of profits, Foy was to continue to receive 25 percent of the net profits received from local franchises if the franchises reached a specified level of fees from their janitorial businesses. Also, since the franchise network by March of 1972 had expanded into Canada, Foy was to receive 25 percent of all net profits received from franchises established in that country. With regard to the split of franchise fees, Foy's share of the franchise fees was increased twofold from 30 percent under the prior agreement, to 60 percent (subject to certain reductions) under the March 14, 1972, agreement.

Also, under the March 14, 1972, agreement, Foy assumed all responsibility, *at his own expense*, for the sales guarantees

made to the local franchisees. As previously explained, this obligated Foy to find new accounts for the franchises and to assist the franchisees in reaching the specified level of fees from their janitorial businesses within a certain time period. If a franchise did not reach the specified level of fees, Foy assumed an unusually large personal responsibility with respect thereto. The March 14, 1972, agreement required Foy, in that instance, to reimburse the franchisee, out of his own funds, the initial franchise fee paid to acquire the local franchise. As previously noted, the fees ranged anywhere from $5,000 to $25,000 per franchise. If Foy had occasion to make any such reimbursement, complete ownership of the local franchise would vest in him, individually.

The March 14, 1972, agreement provided that Foy would receive 25 percent of any sales proceeds if the franchisor sold its ownership rights in the franchise network and the agreement restated Foy's right to veto any proposal to open up a territory to Environment Control franchises or to contract with a new franchisee. Lastly, that agreement provided that if ECI started any new company to perform janitorial services, Foy would receive a 25-percent ownership interest therein.

As we previously indicated, Foy formed a corporation which he named "Expansion Enterprises" sometime prior to October 14, 1971. On October 14, 1971, Foy apparently transferred to Expansion his interest in the profits and fees of Environment Control franchises and of any other businesses established by Foy, Kraft, McCray, and/or ECI in the janitorial or building maintenance industry. Profits and fees due Foy from certain Environment Control franchises were not transferred to Expansion. It appears that the transfer of Foy's profits and fees was simply an effort to shift the income he earned from the Environment Control franchise network from him, individually, to his wholly owned corporation. This transfer to Expansion did not include a transfer of Foy's responsibilities in connection with the Environment Control franchise network, and this transfer apparently did not include Foy's interest in any of the partnerships that had been formed prior to October 14, 1971, to operate local Environment Control franchises.

On June 20, 1972, Foy made a further transfer to Expansion, effective July 1, 1972, which included not only his profits and fees from the Environment Control franchise network but also what-

ever interests he had in the "franchises, partnerships (general or limited), and all other business entities in the building maintenance and janitorial business now or hereafter established." Again, Foy's interest in certain local franchises was excluded from this transfer. Neither ECI nor Kraft was a party to this transfer. Therefore, *insofar as Kraft and ECI were concerned*, under the earlier agreements of October 14, 1969, January 8, 1970, and March 14, 1972 (which had been entered into between Kraft, ECI, and Foy), *Foy individually* (not Expansion) continued to be responsible for Foy's duties and obligations under the prior agreements, and *Foy* (not Expansion) continued to be entitled to Foy's profits and fees and to Foy's interest in the Environment Control franchise network.

A fourth agreement was entered into on July 25, 1974. This time the parties to the agreement were ECI and Foy. Neither Kraft, McCray, nor Expansion was a party to that agreement. By its terms, the agreement only pertained to Environment Control franchises to be established after July 25, 1974, in limited partnership form. The local franchise investors and operators were to be the limited partners, and ECI was to be the named general partner. The initial capital contributions of the limited partners (the amounts of which presumably were comparable to the $5,000 to $25,000 initial franchise fees paid prior to that date), the net profits, and any proceeds from the sale of the franchisor's interest in a local franchise operated in limited partnership form were to be split as follows:

	Initial capital contributions	*Net profits*[6]	*Sales proceeds*
ECI	55%	75%	75%
Foy	45	25	25
Total	100	100	100

Foy continued to have primary if not sole responsibility for assisting the local franchises in finding customers and for meeting the guaranteed sales amounts. If the franchises' sales did not reach the guaranteed amounts, Foy continued to be personally responsible to pay the local franchises any difference between actual sales and the guaranteed amounts.

On July 18, 1975, ECI and Foy entered into another

[6]Foy's net profits interest vested as each local franchise satisfied its guaranteed sales level.

agreement[7] which purportedly terminated the March 14, 1972, agreement as amended on July 25, 1974. The provisions of the 1975 agreement however were similar in most respects to the prior agreements between Foy and ECI. One change reflected in the July 18, 1975, agreement, pertained to the responsibility for the sales guarantees in certain franchise areas. ECI agreed to assume responsibility therefor with respect to the Chicago South; Hickory Hills; South Houston; and Connecticut II franchises. Foy agreed to retain responsibility for the sales guarantees for the franchises located in Northern Virginia; Oklahoma City, North; Oklahoma City, South; Southern Maryland; Valley Forge; and Philadelphia.

The July 18, 1975, agreement is silent as to who was responsible for the sales guarantees after July 18, 1975, with respect to the sales guarantees for all of the other Environment Control franchises (which sales guarantees, as we have indicated, were the responsibility of ECI under the local franchise agreements, but the responsibility of Foy under the March 14, 1972, agreement between ECI and Foy). The lack of reference in the July 18, 1975, agreement to the sales guarantees with respect to the numerous other local franchise locations probably is explained by the fact that the guaranteed sales amounts for those locations had been satisfied. The July 18, 1975, agreement also reconfirmed the following: that Foy had a 25-percent vested net profits interest in numerous local Environment Control franchises;[8] that Foy had a 50-percent

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[7] In January of 1975, Foy sold 3 percent of his net profits interest in the Environment Control franchise network to two individuals for $26,250.

[8] The locations of the local franchisees in which Foy had a vested net profits interest were:

Atlanta-East
Bakersfield
Baltimore-East
Baltimore-West
Cincinnati
Columbus
Connecticut I
Connecticut II
Chanel Islands
Chicago-South
Dallas
Des Moines
East Los Angeles
Eugene
Garden Grove
Glen Ellyn
Hawaii
Hickory Hills
Indianapolis
Irvine
Kansas City, MO
Kansas City, KS
Long Beach
Los Angeles
Madison
Milwaukee I
Milwaukee II
Minneapolis-North
Minneapolis-South
Oakland
Ontario
Orlando
Phoenix
Sacramento
San Bernardino
San Diego
San Fernando
San Francisco
San Jose
Santa Monica Bay
Seattle
South Houston
South Seattle
St. Louis
Stockton
Tampa
Toronto
Tucson
West Portland

vested net profits interest in the Santa Ana franchise (however his net profits interest in the Santa Barbara franchise was reduced from 50 percent to 42.5 percent); that Foy's net profits interest vested in his heirs and assigns; and that Foy was to receive 25 percent of the gain realized by ECI from the sale of ECI's interest as franchisor in a local franchise.

On July 1, 1976, Foy and Expansion transferred their interests in the Environment Control franchise network to ECI for $290,000.[9] The parties to the transfer were ECI, Foy, and Expansion. Cash received by Foy and Expansion at the time of the transfer was $30,000. ECI also gave to Foy and Expansion a $260,000 promissory note payable over 63 months, commencing October 10, 1976, with an interest rate of 7.25 percent per annum. In the written agreement, the purchase price was allocated as follows: (1) $220,000 to Expansion's "royalty rights" in the Environment Control franchises;[10] (2) $35,000 to Foy's "royalty rights" in the Environment Control franchise in Santa Ana, California; and (3) $35,000 to Foy's "royalty rights" in the Environment Control franchise in Santa Barbara, California.

The July 1, 1976, transfer agreement, while quite unclear in many respects, does reflect a transfer to ECI of all of Foy's and Expansion's rights, interests, and responsibilities in the Environment Control franchise network. Only with respect to two cities (namely Kansas City, Kansas, and Oklahoma City, Oklahoma), did ECI transfer all of its interests and responsibilities in the Environment Control franchises located in those cities to Foy and Expansion. The "royalty rights," referred to in the July 1, 1976, transfer agreement, were essentially the same as the net profits interests referred to in prior agreements. Foy's and Expansion's rights to a share of any gain realized by ECI on a sale of the franchisor's interest in any of the Environment Control franchises were transferred to ECI. Foy and Expansion were relieved of all responsibility for the sales guarantees that had been made to the local franchises.

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[9] There was no explanation in the stipulation of facts as to how this amount was arrived at, other than a representation in an affidavit of Kraft that the amount was based on an estimate of the future profits of the franchise network.

[10] The parties to the agreement treated Expansion as owning the vested "royalty rights" with respect to the franchises identified in note 8 *supra*, and with respect to the franchises designated as Chicago South; Hickory Hills; South Houston; and Connecticut II.

OPINION

It is the Federal tax consequences of the July 1, 1976, transfer agreement which give rise to the instant controversy. Petitioners contend that their contract rights in the Environment Control franchise network constituted capital assets and that the transfer thereof constituted a sale or exchange. Respondent contends that petitioners only transferred their rights to receive ordinary income and that the transfer does not qualify as the sale or exchange of capital assets.

In order for the transfer of contract rights, such as those involved herein, to be entitled to capital gain treatment, the contract rights must qualify as capital assets under the broad definition of property found in section 1221, and the contract rights must not constitute any of the types of property excluded from capital gain treatment by sections 1221(1) through 1221(5).[11]

The following policy considerations and rule of construction concerning the term "capital asset" are well established:

> The preferential treatment afforded by the capital gains provisions, 26 U.S.C.A. §§ 1201–1202, 1221–1223, was designed "to relieve the taxpayer from * * * excessive tax burdens on gains resulting from a conversion of capital investments * * *." *Burnet v. Harmel*, 287 U.S. 103, 106, 53 S.Ct. 74, 75, 77 L.Ed. 199. In *Commissioner of Internal Revenue v. Gillette Motor*

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[11] The text of sec. 1221 provides as follows:

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

Transport, Inc., 364 U.S. 130, 134, 80 S.Ct. 1497, 1500, 4 L.Ed.2d 1617, the Court held that it was "the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year." *Commissioner of Internal Revenue v. P.G. Lake, Inc., supra; Burnet v. Harmel, supra.* To effectuate this Congressional purpose, the term "capital asset" is to be construed narrowly. *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46, 76 S.Ct. 20, 100 L.Ed. 29. [*Wiseman v. Halliburton Oil Well Cementing Co.*, 301 F.2d 654, 658 (10th Cir. 1962).]

See also *Elliott v. United States*, 431 F.2d 1149, 1155 (10th Cir. 1970); *Freese v. United States*, 455 F.2d 1146, 1150 (10th Cir. 1972).

No single definitive explanation is available of what types of property qualify as capital assets under section 1221. The Supreme Court in *Commissioner v. Gillette Motor Transport, Inc.*, 364 U.S. 130, 134 (1960), stated that, "not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset." Consistent with that statement, courts generally begin their analysis of this issue by determining what types of property do not constitute capital assets for purposes of section 1221. E.g., *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 265 (1958); *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46, 51–52 (1955); *Commissioner v. Ferrer*, 304 F.2d 125, 129–130 (2d Cir. 1962). We will begin at that same point, and we will mention first the statutory exclusions.

Section 1221 excludes the following five categories of property from the definition of capital assets: (1) Inventory; (2) depreciable personal property or real property used in a trade or business; (3) certain intangible property; (4) accounts receivable acquired in a trade or business; and (5) certain original issue discount obligations. Respondent does not contend that any of the statutory exclusions apply to the contract rights at issue herein.

Court decisions have recognized two additional limitations on the types of property which qualify as capital assets under section 1221. In *Corn Products Refining Co. v. Commissioner*, *supra* at 51, assets that were an integral part of a taxpayer's business were held not to qualify as capital assets. In that case, the Supreme Court held that although corn futures contracts did not fall within the statutory exclusions, profits received

from the purchase and sale of futures contracts entered into in order to assure a reasonably priced supply of corn inventory for the taxpayer's business did not qualify for capital gain treatment because, "Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss." 350 U.S. at 52. Respondent does not contend, herein, that petitioners' contract rights fall within the limitation which *Corn Products* places on capital asset treatment.

The second court-imposed limitation on the types of property which qualify as capital assets was expressed by the Supreme Court in *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958). Thereunder, a mere right to receive ordinary income generally will not qualify as a capital asset. The issue in *P.G. Lake* was whether a transfer of a royalty right associated with the production of oil was a sale of a capital asset. After the transfer, the taxpayer retained a reversionary interest in the underlying oil and gas leases, and the purchaser acquired nothing more than a right to receive a portion of the royalties for a limited period of time. The Supreme Court noted that the amount received for the transfer was virtually equivalent to the amount of royalty income to be received after the transfer. The Court concluded that the only right the taxpayer sold was the right to receive future ordinary income and held that the royalty right was not a capital asset. The Court explained as follows:

> The substance of what was assigned was the right to receive future income. The substance of what was received was the present value of income which the recipient would otherwise obtain in the future. In short consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property. [356 U.S. at 266.]

Subsequent decisions have attempted to clarify the holding of the Supreme Court in *P.G. Lake*. With respect to the broad proposition that amounts received for the transfer of a right to receive future income will not qualify for capital gain treatment, the Fifth Circuit in *United States v. Dresser Industries, Inc.*, 324 F.2d 56 (1963), stated—

> As a legal or economic position, this cannot be so. The only commercial value of any property is the present worth of future earnings or usefulness. If the expectation of earnings of stock rises, the market value of the stock may rise;

at least a part of this increase in price is attributable to the expectation of increased income. The value of a vending machine, as metal and plastic, is almost nil; its value arises from the fact that it will produce income. [324 F.2d at 59.]

In applying the *P.G. Lake* limitation on what property qualifies as a capital asset, courts generally consider the entire economics of a transaction, as suggested by *Dresser Industries* in the above quotation, and evaluate all of the rights of the taxpayer, as well as all of the risks and obligations of the taxpayer associated with his ownership of the property prior to the transfer. For example, in an attempt to explain *P.G. Lake*, we stated in *Guggenheim v. Commissioner*, 46 T.C. 559 (1966)—

The Court in *Lake* was faced with the problem whether a transfer of part of a capital asset is itself the transfer of a capital asset. That part was defined and delineated by the taxpayer in such a manner as to consist essentially of only the rights to income. The transferee assumed few of the risks identified with the holding of a capital asset; he assumed only a nominal risk of his oil payment right decreasing in value and none of the possibility of the oil payment right increasing in value. On the other hand, the taxpayer, after the transfer, retained essentially all of the investment risks involved in his greater interest to the same extent as before the transfer. [46 T.C. at 569.]

Based upon the above statement, whether investment risks were associated with the contract rights transferred is a particularly relevant consideration in determining whether the rights constituted a capital asset.

A further example of how the courts analyze all of the rights and responsibilities of the taxpayer is found in *Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir. 1962). Therein, the Second Circuit analyzed whether the taxpayer's "bundle of rights" included "equitable interests" similar to those of an owner of property, and the Second Circuit specifically mentioned invested capital and investment risks as factors which generally give rise to an equitable interest. 304 F.2d at 131–133. That case concerned the transfer of the right to produce a play. The taxpayer also transferred his rights to control all motion picture, radio, and television productions of the play and his right to receive a share of the proceeds from the distribution of a motion picture of the play. The Second Circuit noted that the right to control all productions of the play (including motion picture, radio, and television productions thereof) were equitable rights which were in the nature of the rights of an owner of

property. It was concluded that those rights constituted "something more than an opportunity, afforded by contract, to obtain periodic receipts of income," and they were held to be capital assets. *Commissioner v. Ferrer*, 304 F.2d at 130.

With regard to the transfer of the additional right to receive a share of the proceeds from the distribution of a motion picture of the play, the court noted that the original copyright owner of the play expressly had reserved both legal and equitable rights in any motion picture of the play. Therefore, the court concluded that the taxpayer did not have an interest in the underlying motion picture, itself, but only an interest in a share of the proceeds from the motion picture. That right did not qualify as a capital asset, but was simply a right to receive ordinary income in the future.[12]

The basic proposition of *P.G. Lake* is still viable. Where the taxpayer *merely* "substituted the right to receive ordinary income from one source for the right to receive ordinary income from another [source]," the rights transferred will not be considered a capital asset. *United States v. Dresser Industries, Inc.*, 324 F.2d at 59.

The substitution of ordinary income was underlying the Tenth Circuit's decision in *Wiseman v. Halliburton Oil Well Cementing Co.*, 301 F.2d 654 (1962). Therein, the Tenth Circuit considered the rights of a taxpayer under a contract to use a patented process and to issue sublicenses to third parties with respect to the process. The taxpayer held an exclusive right to use the process and the right to issue sublicenses to third parties in return for royalties, subject to the approval of the corporation that had developed the process and that had obtained the patent rights thereto. The taxpayer exchanged its exclusive rights to use the process and to issue sublicenses, for nonexclusive rights only to use the process and to receive a portion of the royalties that the corporation was to receive from issuing licenses directly to third parties. The court determined that the conversion of the licensing rights from

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[12] This Court in *Michot v. Commissioner*, T.C. Memo. 1982-128, adopted an approach similar to that taken in *Ferrer* and concluded, among other things, that the taxpayer's royalty interest in a Burger Chef franchise represented a capital asset because it arose out of substantial goodwill and out of the taxpayer's right to exclude others from participating in similar franchises within a specified area, but that the taxpayer's gain attributable to his release of any claim to already earned commissions was ordinary income. 43 T.C.M. 792, at 796; 51 P-H Memo T.C. par. 82,128, at 542-82.

exclusive to nonexclusive rights merely substituted the source from which the taxpayer was to receive ordinary income.

The Tenth Circuit in *Halliburton Oil* further suggested that how the taxpayer acquired the licensing rights and how the licensing rights originated were also relevant factors in determining whether the rights transferred constituted a capital asset. The court emphasized that the taxpayer therein was simply a licensor of the patented process. The taxpayer had not participated in the initial development of the process, nor in obtaining the patent rights thereto, and the taxpayer had no right to control to whom the licenses or sublicenses were given. 301 F.2d at 658.

One situation that illustrates particularly well the proposition that amounts received primarily in lieu of ordinary income will not qualify for capital gain treatment involves the right to receive compensation for personal services. Two Tenth Circuit cases illustrate that situation. In *Elliott v. United States*, 431 F.2d 1149 (1970), the Tenth Circuit considered the tax consequences of payments received by a general agent of an insurance company for the termination of his agency contract under which he had the right to sell insurance in return for commissions. The court held that the contract was only a contract of employment and that the amount received on the termination thereof represented simply a substitute for future ordinary income that the general agent would have received under the employment contract.

In *Freese v. United States*, 455 F.2d 1146 (10th Cir. 1972), the Tenth Circuit considered the tax consequences of amounts received under an employment contract which provided that in addition to a fixed salary, the employee would receive an amount equal to 10 percent of the profits of the employer's business and 10 percent of the proceeds from the sale of any of the employer's assets. The Tenth Circuit again found that since the underlying contract rights were based simply on the employee status of the taxpayer and on the personal services rendered by the employee in that capacity, the amounts received by the employee under the employment contract on the sale of the employer's assets did not qualify for capital gain treatment.

To summarize, in determining whether the taxpayer's contract rights that were transferred constituted a capital asset,

courts generally consider all aspects of the bundle of rights and responsibilities of the taxpayer that were transferred, specifically including the following six factors:

(1) How the contract rights originated;
(2) How the contract rights were acquired;
(3) Whether the contract rights represented an equitable interest in property which itself constituted a capital asset;
(4) Whether the transfer of contract rights merely substituted the source from which the taxpayer otherwise would have received ordinary income;
(5) Whether significant investment risks were associated with the contract rights and, if so, whether they were included in the transfer; and
(6) Whether the contract rights primarily represented compensation for personal services.

We must now apply the law, as set forth above, to the facts of this case. Petitioners contend that their contract rights represented an equitable interest in the Environment Control franchise network that was evidenced by the various contracts they entered into with Kraft and ECI. Petitioners further contend that the contract rights constituted capital assets and that the 1976 disposition thereof was a sale which qualifies for capital gain treatment. Respondent however argues that the contract rights did not qualify as capital assets.[13] Respondent further argues that petitioners have not satisfied the sale or exchange requirement of section 1222. We agree with petitioners.

We reiterate that the relevant written agreements used extremely imprecise and vague language, which makes most difficult our determination as to the character of the rights and obligations of petitioners and of the other parties thereto. We do not consider ourselves bound in every instance by the express terms that the parties used in the various contracts, and we will examine the history and nature of the contract rights in order to determine whether the rights transferred constituted capital assets. See *Freese v. United States*, 455 F.2d at 1151.

Although the Second Circuit separated the taxpayer's bundle of rights in *Commissioner v. Ferrer*, 304 F.2d at 131, into

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[13] If the various contracts between Foy, Expansion, Kraft, and ECI were held to rise to the level of a partnership, then further analysis would be required with respect to whether there was a sale of any unrealized receivables as that term is defined in sec. 751(c). Neither party, however, has raised that issue, and we decline to do so.

separate, distinct rights, petitioners and respondent herein take an "all or nothing" approach and treat petitioners' contract rights collectively. We also adopt that approach, and we note that petitioners' various rights were all so interrelated that no separation of petitioners' rights appears appropriate under the particular facts involved herein.

The key question in our analysis is whether petitioners were so involved in the development and operation of the nationwide Environment Control franchise network that the rights and responsibilities therein which they sold constituted proprietary or equitable interests, similar to those of an owner of property. Foy was one of the founders of the Environment Control business. He was responsible for the name of the company, and it appears that he was the key individual responsible for the rapid growth and expansion throughout the country of Environment Control franchises. He located new franchisees and negotiated building maintenance contracts for the local franchises. Particularly significant is the fact that for most of the years of their involvement with Environment Control both Foy, personally, and Expansion, as a corporation, were responsible for the sales guarantees which were made to the franchises. Such financial and business risks are not typically assumed by mere employees or salesmen who have no ownership interest in the business. The right to veto new franchisees and the right to share in sales proceeds if the "owner" sells his interest, which rights petitioners had, are not typically bestowed upon mere employees and are indicative of the rights of an owner of property.

The ownership interest of Foy (and the source of the ownership interest Expansion eventually received through Foy) is best reflected in the provisions of the January 8, 1970, agreement between Kraft, Foy, and McCray. Therein, Foy was to become a shareholder of the corporation that was to be formed to incorporate the franchise organization. He was to receive 25 percent of all profits of the corporation, 30 percent of the initial franchise fees, and 50 percent of all funds to be placed in a special account for accumulation. That intended division of all corporate profits, fees, and accumulated funds is evidence of an ownership interest. Throughout all of the years, up until the transfer in 1976, Foy and/or Expansion retained essentially the same or an increased share of all profits, fees,

and accumulated funds of the Environment Control franchise network, that was reflected in the first significant agreement between the individuals (namely, the January 8, 1970, agreement).

The fact that the umbrella corporation (that was to be formed to own and operate the Environment Control network) was never formed (and that, instead, Foy and Kraft separately incorporated their respective portions of their ownership interests in the Environment Control business) in no way detracts from the nature of those separate ownership interests. Accordingly, when the interests of Foy and Expansion were transferred in 1976 to ECI, Foy was effectively transferring his direct and indirect (through Expansion) ownership interests in the Environment Control franchise network, and Kraft and ECI were acquiring those ownership interests.

The predominant and overwhelming nature of petitioners' interests in the nationwide franchise network was similar to, if not in fact, that of an equity owner, and therefore petitioners' interests in the Environment Control franchise network constituted substantially "more than an opportunity, afforded by contract, to obtain periodic receipts of income." *Commissioner v. Ferrer*, 304 F.2d at 130. Based upon the facts and law as analyzed above, we conclude that the interests of Foy and Expansion that were transferred in 1976 constituted capital assets.

Having determined that petitioners' contract rights constituted capital assets, it must be determined whether the transfer of petitioners' contract rights constituted a sale or exchange under section 1222. A sale has been defined as a "transfer of property for a fixed price in money or its equivalent." *Commissioner v. Brown*, 380 U.S. 563, 571 (1965). In that regard we previously stated that—

> "Congress intended the words 'sale or exchange' to have a broad meaning, not to be limited to the standard transfer of property by one person to another in exchange for a stated consideration in money or money's worth." *Freeland v. Commissioner*, 74 T.C. 970, 980 (1980) * * * we note that the courts have tended to reject technicalities and focus on the nature of the rights relinquished; if it was a capital asset, the release of a right is generally characterized as a capital gain. [*Arkin v. Commissioner*, 76 T.C. 1048, 1055 (1981).]

Therefore, the terms "sale or exchange" in section 1222 include transactions in which all rights to property or all rights to a portion thereof have been transferred permanently from one party to another.

Petitioners' rights that were transferred to ECI were not merely extinguished, but were rights that were transferred to ECI and that ECI now holds. Furthermore, respondent has conceded this issue in the stipulation of facts.[14] We therefore reject respondent's argument that there was no sale or exchange.

As previously indicated, if rights under a contract constitute a franchise, section 1253[15] may prevent the taxpayer from receiving capital gain treatment on their sale where, among other things, the taxpayer retains a significant interest in the franchise after the sale. Respondent herein, however, does not argue that section 1253 prevents petitioners from receiving capital gain treatment for the transfer in question.[16]

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[14]Stipulation of facts par. 36 "On July 1, 1976 [Expansion] and Foy *sold* all of their rights to ECI as set forth in Exhibit 13-M." (Emphasis added.)

[15]Sec. 1253(a) and (b) provides as follows:

SEC. 1253. TRANSFERS OF FRANCHISES, TRADEMARKS, AND TRADE NAMES.

(a) GENERAL RULE.—A transfer of a franchise, * * * shall not be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, * * *

(b) DEFINITIONS.—For purposes of this section—

(1) FRANCHISE.—The term "franchise" includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area.

(2) SIGNIFICANT POWER, RIGHT, OR CONTINUING INTEREST.—The term "significant power, right, or continuing interest" includes, but is not limited to, the following rights with respect to the interest transferred:

(A) A right to disapprove any assignment of such interest, or any part thereof.

(B) A right to terminate at will.

(C) A right to prescribe the standards of quality of products used or sold, or of services furnished, and of the equipment and facilities used to promote such products or services.

(D) A right to require that the transferee sell or advertise only products or services of the transferor.

(E) A right to require that the transferee purchase substantially all of his supplies and equipment from the transferor.

(F) A right to payments contingent on the productivity, use, or disposition of the subject matter of the interest transferred, if such payments constitute a substantial element under the transfer agreement.

(3) TRANSFER.—The term "transfer" includes the renewal of a franchise * * *

[16]We agree with respondent that sec. 1253 is not applicable to the instant dispute because petitioners did not retain any significant power, right, or continuing interest with respect to anything that they transferred to ECI in the July 1, 1976, agreement, nor did petitioners receive amounts on account of a sale of a franchise that were contingent on the productivity, use, or disposition of a franchise. See sec. 1253(c).

The next issue for our consideration is whether the proceeds received by Foy and Expansion qualify under section 453 for the installment method of reporting. Section 453(b) identifies the following four requirements with respect to reporting a casual sale of personal property on the installment method: (1) The sale must be of personal property; (2) the property must not be inventory with respect to the taxpayer; (3) the sales price must be in excess of $1,000; and (4) payments, if any, received in the year of sale must not exceed 30 percent of the selling price.[17] Also, if the proceeds were received as compensation for personal services, they may not be reported under the installment method. *Sorenson v. Commissioner*, 22 T.C. 321 (1954).

Petitioner contends that the transfer in question was a casual sale of personal property and that all four requirements of section 453 are met. Respondent contends that petitioners did not have any "property" to sell, that there was no sale, and that, if there was a sale, the sales proceeds were received as compensation for personal services and cannot be reported under the installment method. We again agree with petitioners. Our holding on the first issue has determined that the petitioners did transfer property, that the transfer constituted a sale, and that the sales proceeds were not received as compensation for personal services.

In *Realty Loan Corp. v. Commissioner*, 54 T.C. 1083 (1970), affd. 478 F.2d 1049 (9th Cir. 1973), the taxpayer sold its mortgage servicing business. One of the issues concerned

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[17]Sec. 453(b) provides as follows:

SEC. 453. INSTALLMENT METHOD—

(b) SALES OF REALTY AND CASUAL SALES OF PERSONALTY.—

(1) GENERAL RULE.—Income from—

* * * * * * *

(B) a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year) for a price exceeding $1,000,

may (under regulations prescribed by the Secretary or his delegate) be returned on the basis and in the manner prescribed in subsection (a).

(2) LIMITATION.—Paragraph (1) shall apply—

(A) In the case of a sale or other disposition during a taxable year beginning after December 31, 1953 (whether or not such taxable year ends after the date of enactment of this title), only if in the taxable year of the sale or other disposition—

(i) there are no payments, or

(ii) the payments (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 per cent of the selling price.

whether the taxpayer's rights to receive future income under a contract qualified as personal property for installment reporting purposes. In concluding that the contract rights so qualified, the court observed that the mere fact that the amount received by the taxpayer was in lieu of income which would have been received over a period of years was "no reason for prohibiting the use of the installment method of reporting that income." 54 T.C. at 1098.

One further issue for consideration concerns the addition to tax under section 6651(a). An addition to tax under section 6651(a) was determined by respondent for Expansion's failure to file timely its Federal income tax return for its taxable year ending September 30, 1975. Additions to tax under section 6651(a) are presumed correct and are generally upheld, unless the taxpayer presents evidence controverting their applicability. See *Abramo v. Commissioner*, 78 T.C. 154, 163 (1982). Expansion has presented no evidence to dispute respondent's determination. Accordingly, we hold for respondent as to this addition to tax.

In light of the above conclusions,

Decision will be entered for the petitioners in docket No. 10976–81.

Decision will be entered under Rule 155 in docket No. 10977–81.

ESTATE OF JAMES O. SNIDER, DECEASED, KANDACE SNIDER LINDSEY, EXECUTRIX, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 9117–82. Filed January 17, 1985.

Held, a surviving widow's allowance under Texas probate law is a terminable interest and does not qualify for deduction from a Texas decedent's gross estate under sec. 2056, I.R.C. 1954.

C. J. Wofford, Jr., for the petitioner.
James W. Lessis, for the respondent.

KÖRNER, *Judge*: Respondent determined a deficiency in petitioner's Federal estate tax in the amount of $24,530.62. After concessions,[1] the only issue remaining for us to decide is whether the widow's allowance provided by Texas law qualifies for the marital deduction under section 2056(a),[2] or, on the contrary, is a nondeductible terminable interest under section 2056(b). If the allowance qualifies for the marital deduction, we must also determine whether the amount of the deduction is limited to one-half of the allowance.

This case was submitted to the Court under the provisions of Rule 122, upon a set of stipulated facts and exhibits. The stipulation of facts and joint exhibits attached thereto are incorporated herein by this reference and form the basis of our findings of fact.

FINDINGS OF FACT

Petitioner is the Estate of James O. Snider (hereinafter referred to, interchangeably, as the estate or petitioner). Kandace Snider Lindsey filed the petition herein in her capacity as executrix of the Estate; she resided in Dallas, Texas, at the time the petition was filed.

James O. Snider and Gladys G. Snider were married on September 15, 1934, and lived together as husband and wife until the death of Gladys G. Snider on September 14, 1970. Two children were born of the marriage, Larry G. Snider and Kandace Snider Lindsey. On July 23, 1971, James O. Snider executed a last will and testament.

James O. Snider and Rosalie Snider were married on October 3, 1972, and lived together as husband and wife until the death of James O. Snider (hereinafter referred to as decedent) on November 18, 1977. Decedent left his entire

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[1] Included amongst the concessions is petitioner's acknowledgment that respondent's motion for partial summary judgment upon the ground that the value of decedent's homestead property is includable in his gross estate without reduction for the value of any rights of the surviving spouse is in accordance with *Estate of Johnson v. Commissioner*, 718 F.2d 1303 (5th Cir. 1983), revg. 77 T.C. 120 (1981), and should be granted. In *Golsen v. Commissioner*, 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971), cert. denied 404 U.S. 940 (1971), we held that "better judicial administration requires us to follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that court alone." *Golsen v. Commissioner, supra* at 757. Fn. refs. omitted. Appeal in this case would lie to the Fifth Circuit.

[2] All statutory references are to the Internal Revenue Code of 1954 as in effect in the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise noted.

estate to his two children by his first marriage, equally; no provision was made for the surviving spouse under the will. Decedent's will was duly probated, and Kandace Snider Lindsey and Larry G. Snider, decedent's children by his first marriage, were appointed independent coexecutors of the estate.

On May 25, 1978, Rosalie Snider (hereinafter referred to as the widow) sued the independent coexecutors of the estate for an accounting between decedent's separate estate and their community estate in the Probate Court of Dallas County, Texas; the proceeding expanded to include an accounting between the widow's separate estate and community estate. On June 21, 1979, the widow petitioned the probate court to fix a widow's allowance under the provisions of the Texas Probate Code. The widow stated in her petition that she did not have separate property adequate to maintain herself during the first year after decedent's death and requested that a family allowance of $35,000 be fixed.

The probate court entered judgment in favor of the widow and against the estate, in the amount of $69,366.89, on November 26, 1979. This amount included: (1) The widow's share of the net reimbursement to the community property by decedent's estate after reduction by the moneys owed by the widow to the estate,[3] plus (2) a widow's allowance of $13,750. The estate appealed the determination involving the charges made to decedent's separate estate to the Court of Civil Appeals for the Fifth Supreme Judicial District of Texas, at Dallas. The Court of Civil Appeals reduced the amount of the judgment to $44,603.46; the amount of the widow's allowance therein was not modified. The judgment of the Court of Civil Appeals has become final.

The total value of the community property of decedent and the widow on November 18, 1977, the date of decedent's death, was $64,405.02; the total value of decedent's separate property was $352,163.32.[4]

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[3]In other words, the widow's share of the excess of debits to decedent's separate property, over the debits to the widow's separate property.

[4]Consistent with the determinations of the Court of Civil Appeals, the classification of the property in decedent's estate as community or separate, and the values thereof, have been agreed upon by the parties.

Petitioner's Federal estate tax return, filed on February 22, 1979, some 4 months prior to the widow's petition for an allowance, claimed no entitlement to a marital deduction in regard to this allowance, but such claim was made in the petition to this Court filed on April 28, 1982.[5]

OPINION

Petitioner contends that the Texas widow's allowance is subject to the marital deduction and is not taxable as a terminable interest. Petitioner argues, further, that the amount of the marital deduction is the full $13,750, without reduction for the widow's one-half share of the community property. In support of this contention, petitioner argues that: (1) The estate consisted of decedent's half of the community property in the amount of $32,202.51, and decedent's separate property in the amount of $352,163.32, for a total of $384,365.83;[6] (2) the judgment of the probate court, as modified by the Court of Civil Appeals, was paid out of decedent's share of the community property to the extent of $32,202.51; (3) the remaining $12,400.95, of the $44,603.46 judgment, was paid out of decedent's separate property. Therefore, petitioner concludes, it was impossible to pay the $13,750 widow's allowance from community funds as there were not any left after payment of the judgment for $44,603.46, to the extent of $32,202.51, the amount of decedent's share of community property.

Respondent determined, in his notice of deficiency, that the widow's allowance under Texas law is a terminable interest, and, therefore, did not qualify for the marital deduction. Alternatively, respondent contends that if the Texas widow's allowance qualifies for the marital deduction, the amount of said deduction is limited to $6,875. In support of this contention, respondent argues that the allowance should be charged against the full community estate of the deceased husband and the surviving wife, so that the widow's half will bear its burden of such charge.

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[5] Petitioner claimed entitlement to a marital deduction in the amount of the widow's allowance in the administrative proceeding before the Internal Revenue Service. Respondent disallowed the claimed deduction in the statutory notice of deficiency.

[6] Before payment of funeral expenses, debts, taxes, and administrative costs.

The case appears to be one of first impression in the Federal courts, including this Court.

Section 2056(a)[7] provides for a deduction from the value of the gross estate of an amount equal to the value of any interest in property passing from decedent to the surviving spouse. Interests defined as "terminable" by section 2056(b), however, do not qualify as an interest in property to which the marital deduction applies.[8] Congress has indicated that other than the enumerated exceptions to the terminable interest rule, section 2056(b)(1) is intended to be "all-encompassing with respect to various kinds of contingencies and conditions." S. Rept. 1013, at 2, 80th Cong., 2d Sess. 7 (1948).[9]

In order for the widow's allowance to qualify for the marital deduction, and thus escape the terminable interest limitation, the widow's interest therein must be indefeasible and unconditional as of the moment of decedent's death. *Jackson v. United States*, 376 U.S. 503 (1964).

The issue for resolution is thus whether the widow's interest in the allowance provided by Texas Law is indefeasible and unconditional as of the moment of decedent's death, or whether it would "terminate or fail upon the occurrence of an

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[7]Sec. 2056(a) reads as follows:

SEC. 2056(a). ALLOWANCE OF MARITAL DEDUCTION.—For purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsections (b) and (c), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in the property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

[8]Sec. 2056(b) provides, in pertinent part, as follows:

SEC. 2056(b). LIMITATION IN THE CASE OF LIFE ESTATE OR OTHER TERMINABLE INTEREST.—

(1) GENERAL RULE.—Where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, no deduction shall be allowed under this section with respect to such interest—

(A) if an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse); and

(B) if by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse;

[9]In general, the terminable interest rule seeks to assure the possibility of (1) interspousal transfers free of a transfer tax, and (2) the imposition of such tax when the property is transferred to others, by allowing the marital deduction only where the nature of the interest passing to the surviving spouse is such that, if retained until death, it will be taxed in the survivor's estate. If the interest acquired by the surviving spouse is not such as would, if held until death, subject the survivor's estate to liability, it will automatically be a deductible interest. However, the converse is not always true; an interest may be nondeductible even though it may cause estate tax liability upon the death of the surviving spouse. R. Stephens, G. Maxfield & S. Lind, Federal Estate and Gift Taxation, par. 5.06[7][b], at 5-83 (5th ed. 1983).

event or contingency, or on the failure of an event or contingency to occur." Such determination is to be made in accordance with State law. *Hamilton National Bank of Knoxville v. United States*, 353 F.2d 930 (6th Cir. 1965); *United States v. Edmondson*, 331 F.2d 676 (5th Cir. 1964); *Estate of Darby v. Wiseman*, 323 F.2d 792 (10th Cir. 1963); *United States v. Quivey*, 292 F.2d 252 (8th Cir. 1961). The critical factor in applying the terminable interest rule is the possibility under State law of the failure of an interest rather than the actual failure. *Hamilton National Bank of Knoxville v. United States*, *supra*.

The right to a widow's allowance is purely statutory, and is not derived from the common law. *Woolley v. Sullivan*, 92 Tex. 28, 45 S.W. 377 (1898). Under Texas law,[10] a widow is entitled to an allowance, in an amount sufficient for her maintenance, for 1 year after her husband's death.[11] Tex. Prob. Code Ann.

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[10]The statutory provisions pertaining to the award of a widow's allowance are found in Tex. Prob. Code Ann secs. 286–293 (Vernon 1980), which provided, in pertinent part, as follows during the year in issue:

Section 286. Family Allowance to Widows and Minors

Immediately after the inventory, appraisement, and list of claims have been approved, the court shall fix a family allowance for the support of the widow and minor children of the deceased.

Section 287. Amount of Family Allowance

Such allowance shall be of an amount sufficient for the maintenance of such widow and minor children for one year from the time of the death of the testator of intestate. The allowance shall be fixed with regard to the facts or circumstances then existing and those anticipated to exist during the first year after such death. The allowance may be paid either in a lump sum or in installments, as the court shall order.

Section 288. When Family Allowance Not Made

No such allowance shall be made for the widow when she has separate property adequate to her maintenance; nor shall such allowance be made for the minor children when they have property in their own right adequate to their maintenance.

Section 289. Order Fixing Family Allowance

When an allowance has been fixed, an order shall be entered stating the amount thereof, providing how the same shall be payable, and directing the executor or administrator to pay the same in accordance with law.

Section 290. Family Allowance Preferred

The family allowance made for the support of the widow and minor children of the deceased shall be paid in preference to all debts or charges against the estate, except expenses of the funeral and last sickness of the deceased.

Secs. 286 through 293 were amended by Acts 1979, 66th Leg., ch. 24, secs: 15–20, effective Aug. 27, 1979. The 1979 amendment substituted "surviving spouse(s)" for "widow(s)" where appearing and made changes in conformity therewith. These provisions, with some statutory changes enacted from time to time, have been a part of Texas law for more than 50 years.

[11]Historically, the purpose of the allowance statutes was to protect the widow who had been deprived, by the death of her husband, of the means of support which she was accustomed to receive during his lifetime. In pursuance of this policy, the widow was entitled, in order to secure temporary support and reasonable means with which to begin anew the contest for subsistence, to

sec. 287 (Vernon 1980). The allowance is to be fixed after the inventory, appraisement, and list of claims have been approved. Tex. Prob. Code Ann. sec. 286 (Vernon 1980). No formal application for the allowance is necessary. *Connell v. Chandler*, 11 Tex. 249 (1853).[12] The widow does not waive her right to the allowance by her failure to claim it. *In re May's Estate*, 43 S.W.2d 306 (Tex. Civ. App. 1931). Nor will her allowance of a claim while acting as administratrix of her husband's estate estop her afterward from asserting priority of such claim for her widow's allowance. *King v. Battaglia*, 38 Tex. Civ. App. 28, 84 S.W. 839 (1905).

In fixing the allowance, the facts or circumstances existing at the time of the husband's death, and those anticipated to exist during the first year after such death, shall be regarded. Tex. Prob. Code Ann. sec. 287 (Vernon 1980); *Hall v. Fields*, 81 Tex. 553, 17 S.W. 82 (1891). The amount of the allowance is determined by judicial discretion according to the circumstances of each case. *In re May's Estate, supra*; *San Angelo National Bank v. Wright*, 66 S.W.2d 804 (Tex. Civ. App. 1933); *Gonzalez v. Guajardo de Gonzalez*, 541 S.W.2d 865 (Tex. Civ. App. 1976); *Noble v. Noble*, 636 S.W.2d 551 (Tex. Ct. App. 1982). The amount of the allowance must be reasonable under all circumstances. *Jones v. Barlett*, 189 S.W. 1107 (Tex. Civ. App. 1916).

In the event of a widow's death, one who had furnished her with necessities and had become her creditor bona fide, has a right in equity to be substituted to her rights against the estate of her deceased husband. *Baker v. Rust*, 37 Tex. 242 (1872). The Supreme Court of Texas has not decided whether a widow's right to petition for an allowance survives her remarriage.[13]

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receive an allowance for a year's support from the estate of her husband. *Woolley v. Sullivan*, 92 Tex. 28, 45 S.W. 377 (1898); *Pace v. Eoff*, 48 S.W. 2d 956 (Tex. Com. App., judgment adopted 1932); *Noble v. Noble*, 636 S.W.2d 551 (Tex. Ct. App. 1982). The legislature intended that the money furnished to the widow should be spent for perishable articles such as food, clothing, and other necessities of the widow. *Pace v. Eoff, supra* at 960.

[12]The filing of an application is, however, encouraged, in order for the widow to provide such information to the court as will enable it to act intelligently. *Connell v. Chandler*, 11 Tex. 249 (1853). The requirement that an application be filed in order for the allowance to be granted, per se, does not disqualify the widow's allowance for the marital deduction as a terminable interest. The necessity of invoking the legal procedures for the enforcement of a right is not a contingency to the existence of the right upon which the "interest passing to the surviving spouse will * * * fail," within the meaning of the statute. *Estate of Rensenhouse v. Commissioner*, 31 T.C. 818 (1959).

[13]Dicta in *Pace v. Eoff*, 48 S.W.2d at 961, discusses the effect of the death of the widow or other contingencies occurring before the expiration of the year immediately after decedent's death and concludes that in such situation the heirs of the husband might present the facts indicating that

Once the allowance has been fixed and an order has been entered stating the amount thereof and the method of payment, viz, whether in a lump sum or in installments, the order has the force of a judgment and cannot be collaterally impeached. Tex. Prob. Code Ann. sec 289 (Vernon 1980); *Pitner v. Flanagan*, 17 Tex. 102 (1856); *Gray v. McFarland*, 29 Tex. 163 (1867). It may be vacated or reversed only by direct attack or by appeal. *Leaverton v. Leaverton*, 40 Tex. 219 (1874); *King v. Battaglia, supra*. The widow's allowance is not subject to the demand of creditors, except for debts pertaining to the expenses of the last illness and funeral of her husband; claims which the estate of decedent might be entitled to offset against the separate estate of the widow may not be deducted from the amount of the allowance. *Leaverton v. Leaverton, supra* at 223; *Ellis v. Emil Blum Co.*, 242 S.W. 1101 (Tex. Civ. App. 1922).

No allowance is to be made when the widow has separate property adequate for her maintenance. Tex. Prob. Code Ann. sec. 288 (Vernon 1980); *McCanless v. Devenport*, 40 S.W.2d 903 (Tex. Civ. App. 1931); *First National Bank in Orange v. MacFarlane*, 160 S.W.2d 969 (Tex. Civ. App. 1942); *Noble v. Noble, supra*; *Gonzalez v. Guajardo de Gonzalez, supra*.[14]

In *Noble v. Noble, supra*, the Court of Appeals of Texas, in reversing the judgment of the county court which granted the application of a surviving spouse for a widow's allowance, stated;

> While all judicial determinations must be based on the circumstances of each case, they must also be based on the law applicable to each case. It cannot be seriously argued that a court's discretion is ever broad enough to justify disregarding clear and unequivocal statutory mandates. Section 288 of the Probate Code, in simple and unambiguous language, not only requires that a court consider the separate property owned by the surviving spouse as one of the "circumstances" of each case, but also makes such circumstance decisive when such separate property is adequate to the survivor's maintenance. *Where*, as here, *the survivor owns separate property adequate to*

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the amount of the allowance was in excess of her necessities and the probate court would then have the authority to modify its judgment according to the facts proved. Compare *Bente v. Sullivan*, 52 Tex. Civ. App. 454, 115 S.W. 350 (1908), holding, inter alia, that the fact that the widow was married at the time that the judgment was entered did not preclude her from claiming the year's allowance. See also *Little v. Birdwell*, 27 Tex. 688 (1964); *Jones v. Barlett*, 189 S.W. 1107 (Tex. Civ. App. 1916), where the widows in the respective cases had remarried at the time they petitioned for a widow's allowance, but the issue of whether they were precluded from claiming the allowance by reason of their having remarried was not raised.

[14] Cf. *Sloan v. Webb*, 20 Tex. 189 (1857), where a children's allowance was denied upon the finding that they had separate property adequate for their maintenance.

provide maintenance for the survivor for a period of one year, the statutory mandate clearly requires that the application for an allowance be denied. Given that fact, it is idle to speak of a court's discretion.

Section 288 has been construed to require that the allowance fixed for a surviving spouse be determined with reference to the condition of the whole property of decedent during the first year after death and with reference to the necessities of and the circumstances to which the widow was accustomed to have during the lifetime of her husband. *Pace v. Eoff*, 48 S.W.2d 956, 960 (Tex. Comm'n App. 1932, judgment adopted); *Kennedy v. Draper*, 575 S.W.2d 627, 629 (Tex. Civ. App. — Waco 1978, no writ); *Ward v. Braun*, 417 S.W.2d 888 (Tex. Civ. App. — Corpus Christi 1967, no writ). In none of these cases is there a finding concerning the adequacy of the widow's separate property for her maintenance. A statute that states that a widow must be denied an allowance if she owns separate property adequate to her maintenance cannot possibly be construed to require that the determination concerning the granting of an allowance be made by considering only the condition of decedent's property and the widow's needs and lifestyle, without reference to the amount of separate property owned by the widow. Neither *Pace*, *Kennedy* or *Ward* indicate that the amount of separate property owned by the surviving spouse is to be ignored since a realistic consideration of the "needs" of the survivor cannot overlook the assets separately owned by such survivor. If these three cases in fact hold that Section 288 does not require the court to both consider the separate property owned by the survivor and deny an allowance if such property is adequate to the maintenance of such survivor, then the manner in which they "construed" Section 288 is patently erroneous and cannot be accepted.

[*Noble v. Noble*, 636 S.W.2d at 552–553; emphasis added.]

The aforementioned statutes and cases leave no doubt that the Court is required as a matter of law, to make a determination as to whether the widow has separate property adequate for her maintenance. Should the Court find that she has no such property, an allowance, in a sufficient amount to support the widow for 1 year after her husband's death, shall be fixed. *Chifflet v. Willis*, 74 Tex. 245, 11 S.W. 1105 (1889). Absent such finding, the Court lacks authority to grant an allowance. *McCanless v. Devenport, supra*; *First National Bank in Orange v. MacFarlane, supra*; *Noble v. Noble, supra*; *Gonzalez v. Guajardo de Gonzalez, supra*.

Petitioner contends that since the Texas allowance is similar to widow's allowances in Michigan and Ohio, cases interpreting the Michigan and Ohio statutes are highly persuasive and indicate what interpretation the Texas Supreme Court would give to the statutes granting the allowance; petitioner cites *Estate of Green v. United States*, 441 F.2d 303 (6th Cir. 1971), and *Miller v. United States*, an unreported case (N.D.

Ohio 1974, 35 AFTR 2d 75–1571, 74–2 USTC par. 13,039), in support of this contention. Petitioner's reliance on *Green* and *Miller* is misplaced.

In *Green*, the Court of Appeals for the Sixth Circuit determined that the Michigan widow's allowance, section 27.3178 (138), Mich. Stat. Ann. (Callaghan 1980),[15] was subject to the marital deduction and was not taxable as a terminable interest. The Michigan statute did not contain a provision similar to that of section 288, Tex. Prob. Code Ann. (Vernon 1980), providing that "no such allowance shall be made when the widow has separate property adequate to her maintenance." Nor does the Ohio statute, section 2117.20, Ohio Rev. Code Ann. (Page 1976), upheld as a nonterminable interest that qualifies for the marital deduction in *Miller*, contain any such limitation.

It is clear to us that the entitlement of the widow to a year's allowance under Texas law is contingent upon the widow's not having separate property adequate for her maintenance, as determined by the Texas probate court. An interest that might never come into being, should the widow have separate property adequate for her maintenance for 1 year after her husband's death, is not indefeasible and unconditional as of the moment of decedent's death. This is fatal under *Jackson v. United States*, *supra*.

We conclude that the widow's allowance provided by Texas law is a terminable interest that does not qualify for the marital deduction under section 2056. In view of our holding, we find it unnecessary to determine whether the amount of the allowance is payable from community property or from decedent's separate property.

To give effect to the above, as well as concessions by the parties on other issues herein,

Decision will be entered under Rule 155.

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[15] This provision was repealed by Pub. Acts 1978, No. 642, effective July 1, 1979.

ROBERT G. PITCHER, MILLARD G. TRASK, MARY JANE WESTERMARK, M. K. JONES, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 21823-82T. Filed January 23, 1985.

Petitioners unsuccessfully sought a favorable ruling under sec. 367, I.R.C. 1954, regarding an exchange of all the outstanding shares of YPI, a domestic corporation, for a majority interest in YPL, a Canadian corporation holding the YPI shares as its only asset, followed by a public offering by YPL of its shares on a Canadian stock exchange. *Held*, in light of all the facts and circumstances, respondent's ruling that petitioners' transfer had as one of its principal purposes the avoidance of Federal income taxes was unreasonable.

Richard A. Munson, Isabel S. Schneider, and *Daniel Manry*, for the petitioners.

Alfred C. Bishop, Jr., Deborah Y. Clark, and *L. Michael Wachtel*, for the respondent.

OPINION

TANNENWALD, *Judge*: Respondent determined that petitioners' transfer of stock to a Canadian corporation was "in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes," within the meaning of section 367,[1] and that the transaction thus fails to qualify for nonrecognition treatment under section 351 or 368(a)(1)(B). Having met all jurisdictional prerequisites,[2] petitioners timely filed their petition for a declaratory judgment with this Court pursuant to section 7477(a).[3] The issue presented for our

[1]Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue, and all Rule references are to this Court's Rules of Practice and Procedure.

[2]See sec. 7477(b). See also *infra* note 14.

[3]Sec. 7477(a) provides:

(1) IN GENERAL.—In a case of actual controversy involving—

(A) a determination by the Secretary—

(i) that an exchange described in section 367(a)(1) is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes, or

(ii) of the terms and conditions pursuant to which an exchange described in section 367(a)(1) will be determined not to be in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes, * * *

* * * * * * *

upon the filing of an appropriate pleading, the Tax Court may make the appropriate declaration

decision is whether respondent's determination was reasonable.

The case was submitted for decision on the stipulated administrative record under Rule 122. This reference incorporates the administrative record herein. We assume the facts as represented therein to be true for the purposes of this proceeding. Rule 217(b)(1).

At the time they filed their petition, petitioners Millard F. Trask and M.K. Jones resided in Billings, Montana; petitioner Robert G. Pitcher resided in Red Lodge, Montana; and petitioner Mary Jane Westermark resided in Shelby, Montana. Each is experienced in the oil and gas business, and none of the petitioners is related to the others in any way. Petitioners are each considered U.S. shareholders.

Before completion of the transaction in issue, petitioners held approximately 63 percent of the 1,622,800 issued and outstanding shares of Yellowstone Petroleums, Inc. (YPI).[4] YPI, a Montana corporation engaged in the oil and gas exploration business, owned property in Montana, North Dakota, and Colorado; all of its business activities have taken place in the United States. The remaining 37 percent of the YPI shares was held by Canadian corporations and individuals,[5] i.e., not "U.S. shareholders."

In 1980, YPI had lease interests in numerous oil and gas properties in the United States, but found itself with insufficient cash to commence drilling on these properties. Under the typical lease agreements, YPI was required to commence drilling in order to retain its interest in the properties; if these drilling obligations were not met, YPI faced a substantial risk of losing potentially profitable property interests. Moreover,

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referred to in paragraph (2). Such declaration shall have the force and effect of a decision of the Tax Court and shall be reviewable as such.

(2) SCOPE OF DECLARATION.—The declaration referred to in paragraph (1) shall be—

(A) in the case of a determination referred to in subparagraph (A) of paragraph (1), whether or not such determination is reasonable, and, if it is not reasonable, a determination of the issue set forth in subparagraph (A)(ii) of paragraph (1) * * *

[4] Of the 1,622,800 shares, petitioner Pitcher held 348,120 shares (21.5%), petitioner Trask held 470,920 shares (29.0%), petitioner Westermark held 113,760 shares (7.0%), and petitioner Jones held 90,000 shares (5.5%). There is some confusion as to whether petitioner Jones owned 90,000 or 45,000 shares of YPI before the exchange with YPL, but, in any event, after the exchange, he held 90,000 shares of YPL. Resolution of the question of 45,000 versus 90,000 shares before the exchange is not necessary to our decision herein.

[5] Kandex Resources & Development, Inc., held 240,000 shares, Locke Asset Management, Ltd., held 240,000 shares, Calto Development, Ltd., held 108,000 shares, and Alfred D. Friesen held 12,000 shares.

READEX FICHE

YPI needed capital to acquire additional properties. The management of YPI found that a public stock offering would be the most rapid and cost-effective method with which to raise the requisite capital. A domestic public offering would have entailed excessive expenditures of time and money because of the necessity of registration of the offering with the U.S. Securities and Exchange Commission (SEC). Thus, management decided upon a foreign public offering. Canada was chosen as the optimal location for the offering because of the geographic location of YPI, prior joint venture dealings and business contacts with Canadian investors, the relation of one of the Canadian shareholders with a brokerage firm in Calgary, and the belief that the Canadian market would be more receptive to the offering than would the U.S. market.

Initially, management considered offering YPI stock on a Canadian exchange. However, the SEC became aware of this plan and expressed its concern about the fact that YPI had not registered its offering. To avoid problems with U.S. securities laws, attorneys for YPI advised the SEC that severe restrictions would be placed on the offered YPI shares, namely, a legend stating that transfers were to be made in Canada, only, and that no transfers were to be made to any citizen or resident of the United States, or to any agent of U.S. citizens or residents.

However, these restrictions so impaired the marketability of the YPI shares that the transfer agent and underwriter would not accept the YPI stock so legended. Thus, management decided to form a Canadian corporation—Yellowstone Petroleums, Ltd. (YPL)—to act as a holding company with its only assets being all the outstanding stock of YPI, and to offer the shares of YPL on the Canadian exchange. The transaction to which petitioners' ruling request referred, entailed (1) an exchange by the eight YPI shareholders of all their outstanding YPI shares for an equal number of YPL shares, and, shortly thereafter, (2) a public offering on a "best efforts" basis[6] for between 500,000 and 1 million shares of YPL on a Canadian exchange. After the first step of the transaction, YPI would become a wholly owned subsidiary of YPL, the former

[6]It appears that the public offering, which was eventually made, was accomplished on an underwriting, rather than on a "best efforts" basis, but this difference has no bearing on our decision herein.

shareholders of YPI would own 84.6 percent of the 1,942,800 YPL shares issued and outstanding, and petitioners (the former YPI shareholders who were "U.S. shareholders") would own 52.6 percent of the YPL shares. After the second step, the former YPI shareholders would own between 55.8 percent and 67.3 percent of YPL, and petitioners would own between 34.8 percent and 41.9 percent of the YPL shares.[7]

On February 3, 1981, in order to accomplish their stated business purpose, petitioners effected the proposed transaction with the sale of 1 million shares of YPL on the Alberta Stock Exchange (ASE) for $2.60 (Canada) per share. After completion of the transaction, the former YPI shareholders owned 55.8 percent of the YPL shares, and petitioners owned 34.8 percent. As of the date of the transaction, petitioners held three of the six positions on the YPL board of directors and held the offices of president, chairman of the board, vice president, chief financial officer, and secretary/treasurer of YPL. All of the former YPI shareholders then held four YPL positions. The directors and senior officers of YPL together held options to purchase a total of 175,000 additional common shares of YPL.

YPL and YPI represented to respondent that petitioners had no intention of disposing of their stock in YPL, and that YPL had no intention of disposing of its YPI stock or to liquidate YPI or otherwise to have YPI or YPL abandon the oil and gas business. Petitioners' transfer of their YPL shares would require, pursuant to a legend inscribed on their YPL share certificates in accordance with Alberta law, (1) filing a prospectus with the Alberta Securities Exchange Commission (ASC), or (2) filing a statement of material facts with the ASC and ASE, or (3) obtaining an order from the ASC, or (4) following Canadian procedures for a transfer pursuant to a consolidation, amalgamation, merger, or reorganization. Under Canadian law, the last of these would require approval of three-

[7] Upon incorporation of YPL on Jan. 28, 1980, each YPI shareholder was issued 1 share of YPL stock. On Mar. 10 of that year, 20,000 shares of YPL stock were issued to each of 16 Canadian corporations and individuals, one of whom, Albert D. Friesen, was also a YPI shareholder. Apparently, YPL issued 1,622,792 new shares to engage in the exchange, giving the YPI shareholders 1,642,800 shares of YPL and giving petitioners 1,022,800 of the YPL shares. After the sale to the public of 500,000 or 1 million shares, there would be issued and outstanding 2,442,800 or 2,942,800 shares of YPL. The eight YPI shareholders would own 1,642,800 shares, petitioners would own 1,022,800 shares.

fourths of the YPL shareholders, disclosure to the ASE, and acceptance by the ASE. A transfer by YPL of all of its YPI shares would, under Canadian law, require approval by the board, majority shareholder approval, and acceptance for filing of a notice to the ASE.

Petitioners requested a ruling from respondent on the proposed transaction on July 15, 1980. Respondent issued an initial adverse ruling letter with respect to the transaction on February 27, 1981.[8] In their protest[9] to this ruling, dated April 11, 1981, petitioners offered to enter into a closing agreement with respondent "whereby [petitioners] would recognize any inherent gain not recognized under any other provisions of the Internal Revenue Code if at any time prior to January 1, 1985, YPL should dispose of any YPI stock." On June 3, 1982, respondent issued a final adverse ruling on the transaction and declined to enter the proposed closing agreement.[10]

Section 367[11] provides that for certain exchanges and reorganizations in which property is transferred by a U.S. person to a foreign corporation, the corporation will not be considered to be a "corporation" for tax purposes unless the taxpayer establishes to respondent's satisfaction that the exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. Because corporate status is essential to nonrecognition treatment under sections 351 and 368(a)(1), section 367 requires that taxpayers obtain a favorable ruling in order to qualify incorporations and reorganizations involving transfers to foreign corporations for nonrecognition treatment. The present case falls within the requirements of section 367 due to the

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[8]See Private Letter Ruling 8121093 (Feb. 27, 1981).

[9]See Rev. Proc. 77-5, sec. 4.01, 1977-1 C.B. 536, 538, currently updated by Rev. Proc. 84-1, sec. 9.22, 1984-1 C.B. 342, 350.

[10]See Private Letter Ruling 8235071 (June 3, 1982).

[11]For the years in issue, sec. 367 states, in relevant part:

If, in connection with any exchange described in section 332, 351, 354, 355, 356, or 361, there is a transfer of property (other than stock or securities of a foreign corporation which is a party to the exchange or a party to the reorganization) by a United States person to a foreign corporation, for purposes of determining the extent to which gain shall be recognized on such transfer, a foreign corporation shall not be considered to be a corporation unless, pursuant to a request filed not later than the close of the 183d day after the beginning of such transfer (and filed in such form and manner as may be prescribed by regulations by the Secretary), it is established to the satisfaction of the Secretary that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

coverage of petitioners' two-step transaction by section 351.[12]

Section 367 initially appeared in the Code as section 112(k) of the Revenue Act of 1932, Pub. L. 72–154, 47 Stat. 169. Congress' purpose in enacting section 112(k) was to close a "serious loophole" in existing tax law that allowed taxpayers to avoid taxation of the capital gain on the sale of appreciated securities by transferring the securities to corporations "organized in countries imposing no tax upon the sale of capital assets." S. Rept. 665, 72d Cong., 1st Sess. (1932), 1939–1 C.B. (Part 2) 496, 515 (hereinafter cited as 1932 Senate Report); H. Rept. 708, 72d Cong., 1st Sess. (1932), 1939–1 C.B. (Part 2) 457, 471 (hereinafter cited as 1932 House Report). Until 1976, the core substantive concept in section 112(k) (and later section 367)—whether the transaction in question was "in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes"—remained unchanged. See Aidinoff & Mosley, "Section 367(a)—Janus Revisited," 36 Tax Law. 629, 630 (1983).

In 1968, in order to make clear the circumstances under which an advance ruling would be granted under section 367, the Service published detailed guidelines describing when a favorable ruling would or would not ordinarily be issued. Rev. Proc. 68–23, 1968–1 C.B. 821 (the Guidelines). For purposes of this case, the relevant general rule is that "a favorable ruling under section 367 of the Code will not be issued for an exchange described in section 351 of the Code where the property to be transferred to the foreign corporation is * * * stock or securities." Guidelines, sec. 3.02(1)(a)(iii). However, respondent recognized in another section of the Guidelines, section 3.03(1)(d), a specific exception to the general rule in section 3.02(1)(a). This exception provides that a favorable ruling will ordinarily be given—

> Where the stock of a domestic corporation is acquired in exchange for stock of a foreign corporation and immediately after the exchange the shareholders of the acquired domestic corporation do not own directly or indirectly, within the meaning of section 958 of the Code, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of the acquiring foreign corporation, unless the assets of the acquired domestic

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[12] Respondent does not contend that the exchange involved herein fails to qualify for nonrecognition under sec. 351, if the requirements of sec. 367 are met. See Rev. Rul. 78–294, 1978–2 C.B. 141.

corporation consist principally of stock or securities. [Guidelines, sec. 3.03(1)(d).]

Notwithstanding the foregoing specific rules, Guidelines section 2.02 sets forth an overall test as follows:

> In reviewing each request for ruling to determine whether a favorable section 367 ruling should be issued under the guidelines, the Service reserves the right to issue an adverse ruling if, *based on all the facts and circumstances of a case*, it is determined that the taxpayer has not established that tax avoidance is not one of the principal purposes of the transaction. Similarly, a taxpayer shall be free to establish that based on all the facts and circumstances of the taxpayer's case a favorable ruling under section 367 of the Code should be issued, notwithstanding a contrary statement or implication contained in the guidelines. [Emphasis added.]

Thus, under the Guidelines, failure to fit a transaction within a specific guideline is not necessarily fatal on the question of principal purpose. See *Kaiser Aluminum & Chemical Corp. v. Commissioner*, 76 T.C. 325, 343–344 (1981); *Dittler Bros., Inc. v. Commissioner*, 72 T.C. 896, 913 (1979), affd. without published opinion 642 F.2d 1211 (5th Cir. 1981).[13]

In 1976, as part of the Tax Reform Act of 1976, Pub. L. 94–455, 90 Stat. 1520, Congress restructured section 367 and provided for declaratory judgment jurisdiction of this Court to give taxpayers a forum in which to protest respondent's adverse rulings under that section. The restructuring did not change the "principal purposes" language carried forward from section 112(k), and it is this portion of the statute that is essentially at issue in the present case.[14] Petitioners contend that, because the transaction fits within the mold of Guidelines section 3.03(1)(d), and the facts and circumstances indicate that business reasons primarily motivated the transaction,[15] respondent's conclusion that tax avoidance was one of the principal purposes of the transaction in issue is not supported by substantial evidence. Further, petitioners argue

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[13] See also Private Letter Ruling 8420032 (Feb. 10, 1984), where respondent applied this overriding guideline in favor of the taxpayer.

[14] We note that the Tax Reform Act of 1984, Pub. L. 98–369, 98 Stat. 494, significantly changed sec. 367 and repealed sec. 7477 respecting transfers after Dec. 31, 1984. These amendments have no bearing on the transaction here in question.

[15] In the ruling request and subsequent material submitted to respondent, representations were made that business purpose was "overriding" and that the "sole purpose" of the proposed transaction was to raise capital. We do not consider that we are bound by those representations which, after all, deal with the ultimate conclusion upon which a decision in this case rests.

that respondent's refusal to enter into an appropriate agreement demonstrates the unreasonableness of respondent's ruling.

Respondent, claiming that the appropriate standard of review is whether his determination was arbitrary and capricious, asserts that section 3.03(1)(d) does not cover this transaction, that the purpose for the transaction was deferral and avoidance of U.S. tax, and that the facts and circumstances thus indicate that respondent's ruling is reasonable.

Section 7477(a)(2), as noted above, requires this Court to declare, inter alia, "whether or not [respondent's] determination is reasonable." In the three cases decided by this Court to date under section 7477, we have consistently held that the proper standard of review under this statute is the "substantial evidence" standard. See *Kaiser Aluminum & Chemical Corp. v. Commissioner, supra* at 343; *Hershey Foods Corp. v. Commissioner*, 76 T.C. 312, 317 n. 7 (1981); *Dittler Bros., Inc. v. Commissioner, supra* at 909–910. Respondent argues that the "mood" of Congress, as expressed in the enactment of sections 112(k), 367, and 7477, indicates that we are to give respondent almost unlimited discretion in ruling on section 367 transactions. We do not agree. As we held in *Dittler Bros.*, by directing the Court to determine the reasonableness of respondent's section 367 determinations, Congress, in 1976, withdrew the unbridled discretion that respondent perhaps was once given.[16] The proper test, falling "somewhere between the arbitrary and capricious test and a simple redetermination" (72 T.C. at 910), is the substantial evidence test, under which we are to determine whether respondent's ruling is supported by " 'such relevant evidence as a reasonable mind might accept as adequate to support a conclusion.' " 72 T.C. at 909 (citation omitted). We reject respondent's plea that we reconsider our prior decisions, abandon the "substantial evidence" test, and

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[16] See H. Rept. 94-658 (1975), 1976-3 C.B. (Vol. 2) 695, 933; S. Rept. 94-938 (1976), 1976-3 C.B. (Vol. 3) 49, 301, in which the Committees cite as problems with the pre-1976 law that "the statute requires the Commissioner's not the Court's satisfaction" and that "since the law requires the satisfaction of the Commissioner, a taxpayer is unable to go through with a transaction and litigate in the courts the question of whether tax avoidance is one of the purposes of the transactions." See also *Gerli v. Commissioner*, 668 F.2d 691, 696, 698 (2d Cir. 1982), revg. on another ground 73 T.C. 1019 (1980). ("The Committee reports on the 1976 Act expressed an intent to limit, at least prospectively, the discretion of the Commissioner," and, with respect to pre-1976 transactions, "the Secretary's discretion was surely not intended to be limitless.")

adopt an "arbitrary and capricious" test.[17]

After a careful review of the entire administrative record, we conclude that respondent's determination that one of petitioners' principal purposes was the avoidance of Federal income taxes is not supported by substantial evidence, and is thus unreasonable.

Our analysis begins with the Guidelines, which were followed by respondent at the time of his adverse determination regarding petitioners' transaction. See Rev. Proc. 77–5, sec. 3.03, 1977–1 C.B. 536, 538. Petitioners argue that, because their transaction fits section 3.03(1)(d) of the Guidelines as they interpret it, upholding respondent's ruling would constitute subversion of their reasonable reliance on the Guidelines in structuring their affairs. Respondent claims that, because the transaction is covered by section 3.02(1)(a) of the Guidelines as he interprets it, the unfavorable ruling is reasonable. In interpreting the Guideline provisions, both parties expend much effort arguing whether "the shareholders of the acquired domestic corporation," i.e., the group under section 3.03(1)(d) that must own 50 percent or less of the acquiring foreign corporation immediately after the exchange, encompasses only the U.S. shareholders of YPI (petitioners) or all the former shareholders of YPI. Moreover, the parties are in dispute over whether the control test in section 3.03(1)(d) includes a determination of "effective, practical control" where the 50-percent control test is not met. Although these issues are interesting, they are subsidiary to the basic issue in this and other cases under section 367, namely, whether the transaction had, as one of its principal purposes, tax avoidance. In light of our conclusion on that issue, we do not reach the "shareholder" definition issue or the issue of "effective, practical control" posed by the parties.

The Guidelines are not positive law, but were promulgated to give taxpayers guidance regarding respondent's ruling policy under the statutory "principal purposes" standard (*Dittler Bros., Inc. v. Commissioner*, 72 T.C. at 914)—a standard never elucidated by Congress or by respondent, see Himmel, "The Section 367 Toll-Charge Requirement: Impact of the *Gerli* Case," 8 International Tax J. 276, 284 (1982).

[17] See discussion as to the semantic problems involved in applying the two tests in *Dittler Bros., Inc. v. Commissioner*, 72 T.C. 896, 929–931 (1979) (Tannenwald, J., dissenting).

Although Congress, as respondent maintains, did generally approve of the Guidelines in 1976, it clearly indicated that declaratory judgment relief for taxpayers issued adverse rulings under section 367 was necessary because "there may be cases where these standards are inappropriate or are not being correctly applied." H. Rept. 94–658 (1975), 1976–3 C.B. (Vol. 2) 695, 933; S. Rept. 94–938 (1976), 1976–3 C.B. (Vol. 3) 49, 301. Hereinafter cited as 1975 House Report and 1976 Senate Report. It is section 367, itself, and not the specific Guidelines provisions, that is the positive law which respondent must follow in issuing rulings; the Guidelines serve only to implement the principal purposes test in section 367.[18] Indeed, the Guidelines, themselves, reflect this fact in section 2.02 (see *supra* p. 91), which overrides the application of specific provisions of the Guidelines by allowing either the Service or a taxpayer to argue principal purposes from all the facts and circumstances. Accordingly, this Court has consistently rejected a rigid, mechanical application of the Guidelines. *Kaiser Aluminum & Chemical Corp. v. Commissioner, supra* at 343–344, 346–347; *Dittler Bros., Inc. v. Commissioner, supra* at 912–914; see generally Johnson, "A Criticism of the Internal Revenue Service Standards Used in Evaluating Section 367(a)(1) Ruling Requests," 61 Taxes 749, 752–753 (1983).[19]

Thus, we direct our attention not to whether petitioners' transaction fits the detailed requirements for a favorable ruling under Guidelines section 3.03(1)(d), but, instead, to whether, given all the facts and circumstances disclosed in the administrative record, respondent's determination that the transaction had tax avoidance as one of its principal purposes is supported by substantial evidence.

As we held in *Dittler Bros., Inc. v. Commissioner, supra*, the proper test for whether tax avoidance was a principal purpose is not, as respondent urges, whether a tax-avoidance purpose "figures prominently as a reason for the plan," or whether

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[18] See H. Rept. 98–432 (Part 2) 1308 (1984) (outlining present law in the context of 1984 revisions to sec. 367).

[19] Respondent again maintains that the Guidelines create a presumption of tax avoidance and require an automatic decision by this Court in his favor where the only exchange is stock of a domestic corporation for stock of a foreign corporation and, but for sec. 367, sec. 351 would apply. In his zealousness, respondent purports to quote sec. 2.02 of the Guidelines and grudgingly admits that petitioners may "overcome the burden of this presumption." In point of fact, the quoted language does not appear in sec. 2.02.

business reasons are "so overwhelming as to make tax avoidance a negligible concern," but, rather, whether the transaction had "as one of its 'first-in-importance' purposes the avoidance of Federal income taxes." 72 T.C. at 915.

Respondent argues that petitioners' transaction was precisely the type which Congress had in mind when it enacted section 367—"the classic avoidance transaction." Acknowledging that the "concept of tax avoidance is not always an easy one to grasp or define," respondent finds tax avoidance in the fact that YPL could have sold its appreciated YPI stock free of U.S. tax at any time before the date on which section 897[20] overrides the treaty between the United States and Canada exempting the gain from tax,[21] and thus avoided U.S. income tax on the appreciation accruing in YPI. According to respondent, petitioners' business purpose arguments are "weak" in light of what he claims to be substantial evidence of tax avoidance and petitioners' effective control of YPL—the instrument through which the tax on YPI's appreciation could be avoided. Pointing to the fact that the delayed effective date of section 897 gives the *foreign* YPL shareholders an incentive to avoid taxes causing the YPI shares to be sold quickly, respondent concludes that "the facts here do not lead one to an inevitable conclusion that tax avoidance played an immaterial role."

Petitioners, citing the "first in importance" standard, claim that they adequately demonstrated that business, not tax, considerations dominated their thinking. They point to the need for capital, the relative efficiency and effectiveness of a Canadian public offering to obtain the capital, the need to form YPL in order to make the offered shares marketable, and

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[20]Sec. 897 imposes a tax on dispositions by nonresident aliens and foreign corporations of a "United States real property interest." The parties apparently agree that the YPI stock represents such an interest.

[21]The current treaty was signed on Sept. 26, 1980, amended by protocols signed June 14, 1983, and Mar. 28, 1984, and ratified on Aug. 16, 1984. The effective date provision of sec. 897 states that treaties cease to override sec. 897 as of Dec. 31, 1984, unless a treaty is renegotiated to resolve problems of conflict with sec. 897, and signed between Jan. 1, 1981, and Jan. 1, 1985. In that case, the date specified in the new treaty (not later than 2 years after the treaty was signed) is to be substituted for the Dec. 31, 1984, override date. Although the parties at one point agreed that sec. 897 would take precedence over the treaty with Canada beginning Jan. 1, 1985, there now appears to be a dispute on this issue. Petitioners contend that the override date is Aug. 16, 1984, the ratification date, while respondent argues that, because of a treaty provision, sec. 897 will not override the treaty until Jan. 1, 1986. Our disposition of the issue of tax-avoidance purpose makes it unnecessary to decide on what date the treaty will actually be overridden; thus, we leave this decision to another day.

the restrictions on the sale of the YPI shares by YPL. Noting that they remain willing to agree to recognize any inherent gain not otherwise recognized on the sale of the YPI shares, petitioners conclude that respondent's determination ignores "both a business purpose for the transaction and a lack of interest on the part of Petitioners to avoid tax."

We agree with petitioners. Respondent's argument that one of the principal purposes here was tax avoidance really breaks down into two parts—that there was a *potential* for tax avoidance inherent in the transaction, and that taxes were *deferred* as a consequence of the transaction. Respondent argues that potential avoidance was within the scope of Congress' aim in passing the predecessor to section 367. Describing an example of the kind of transaction to be covered by section 112(k), the committee reports stated—

> For example, A, an American citizen, owns 100,000 shares of stock in Corporation X, a domestic corporation, which originally cost him $1,000,000 but now has a market value of $10,000,000. Instead of selling the stock outright A organizes a corporation under the laws of Canada to which he transfers the 100,000 shares of stock in exchange for the entire capital stock of the Canadian company. This transaction is a nontaxable exchange. The Canadian corporation sells the stock of Corporation X for $10,000,000 in cash. The latter transaction is exempt from tax under the Canadian law and is not taxable as United States income under the present law. The Canadian corporation organizes Corporation Y under the laws of the United States and transfers the $10,000,000 cash received upon the sale of Corporation X's stock in exchange for the entire capital stock of Y. The Canadian corporation then distributes the stock of Y to A in connection with a reorganization. By this series of transactions, A has had the stock of X converted into cash and now has it in complete control. [1932 Senate Report, *supra*, 1939–1 C.B. (Part 2) at 515; 1932 House Report, *supra*, 1939–1 C.B. (Part 2) at 471.]

Respondent argues that regardless of the fact that, in this example, the appreciation in the value of the X stock, represented by corporation Y's cash, will be taxed if and when there is an eventual distribution to A, Congress enacted the predecessor to section 367 so as to attack the *potential* avoidance resulting from A's control over the distribution. This Court has applied this rationale and held that a potential for tax avoidance "should be an element to be considered" in determining whether a tax-avoidance purpose pervaded the transaction. *Dittler Bros., Inc. v. Commissioner*, 72 T.C. 896, 917 (1979), affd. without published opinion 642 F.2d 1211 (5th

Cir. 1981); cf. *Hershey Foods Corp. v. Commissioner*, 76 T.C. 312, 318 (1981) (if no tax-avoidance potential exists, tax avoidance cannot be a principal purpose).

However, Congress has also stated that this potential, *alone*, is not enough. Enumerating the problems with the pre-1976 enforcement of section 367, the committee reports mention as an area of difficulty "situations where the IRS requires a U.S. shareholder to include certain amounts in income as a toll charge even though there is no present tax-avoidance purpose but, rather, only the existence of a potential for future tax avoidance." 1975 House Report, *supra*, 1976–3 C.B. (Vol. 2) at 932; 1976 Senate Report, *supra*, 1976–3 C.B. (Vol. 3) at 301.[22] A potential for avoidance, then, is not dispositive, but is only one of the "facts and circumstances" to be considered, and the actual likelihood of the future actions that will result in avoidance is highly relevant. See *Kaiser Aluminum & Chemical Corp. v. Commissioner*, 76 T.C. 325, 347 (1981).[23] The example given in the 1932 House Report, *supra*, and 1932 Senate Report, *supra*, is devoid of any reference to business purpose, which has always been a critical element in finding the proscribed purpose contained in section 367. We reject respondent's attempt to persuade us to convert a distinguishable example in a legislative committee report into a mandate which establishes an inflexible rule—a status not even adopted by respondent in his own Guidelines.

In the instant case, future tax avoidance could result only if YPL sells its YPI shares before the date on which section 897 becomes effective.[24] There is indeed a potential for avoidance

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[22] Even the 1932 House Report and 1932 Senate Report, cited at p. 90 *supra*, inferred that not all transactions of the type of the example given, would be tainted by a tax-avoidance purpose ("while it is probable that the courts will not hold all transactions of this nature to be tax-free exchanges").

[23] Indeed, if potential avoidance were intended to be enough, Congress could simply have denied corporate status in cases in which appreciated property is transferred outside the country, and not permitted a taxpayer to show that tax avoidance was not a principal purpose of the transfer. In this connection, we recognize that the Tax Reform Act of 1984 appears to make an exchange, such as involved herein, taxable, but that act is not applicable herein (see *supra* note 14) and respondent has not argued otherwise.

[24] See *supra* note 21. A sale by petitioners of their YPL shares does not seem to have the potential to avoid taxes, as petitioners' ruling request asks for a basis in the YPL shares equal to the basis in the transferred YPI shares. See sec. 358(a).

Respondent argues that petitioners could avoid taxes even after the override date by changing the structure and asset mix of YPI and thus avoiding the tax under sec. 897. Suffice it to say that the definitions under sec. 897 are difficult enough so that we are unimpressed by respondent's crystal-ball argument. See Feder & Parker, "The Foreign Investment in Real Property Tax Act of 1980," 34 Tax Law. 545, 555–558 (1981).

of U.S. taxes on the appreciation in YPI if this occurs. The question, however, is whether substantial evidence supports respondent's determination that, on *all* the facts and circumstances, tax avoidance was a principal purpose of this transaction.

YPI clearly needed capital in order to continue profitable operations, and the management of YPI decided that a public offering was the optimal approach. A foreign offering avoided the time and money involved with the SEC registration needed for a domestic offering. Management chose Canada due to prior dealings with Canadian investors, geographic proximity, and a favorable market outlook. YPL was formed to avoid marketability problems which, due to SEC restrictions, would accompany a U.S. offering or, indeed, a Canadian offering, of YPI stock. These restrictions would not only have been imposed on the subsequent transfers of YPI stock offered to the public, but would have operated directly on the offering of the shares, themselves. They appear to be far more onerous than those involved in the YPL offering, where the restrictions seem to have been imposed only on the subsequent transfers of the YPL shares in the hands of former YPI shareholders. If the restrictions accompanying the Canadian offering had not been less onerous, it would seem that the Canadian underwriter and transfer agent would have been as unwilling to undertake an offering of YPL shares as they were in respect of an offering of YPI shares in Canada. Finally, we think it significant that the initial plan was to offer YPI shares, in which case section 367 would have had no relevance. It was only after the SEC voiced its concern, and after the restrictions proposed to be attached to the offering of YPI shares were found to be unacceptable by the Canadian underwriter and transfer agent, that the decision to offer shares of YPL was made and section 367 came into play.[25]

We are unimpressed by respondent's argument that petitioners, because of their board positions and offices and their options to purchase YPL stock, had practical control of YPL sufficient to enable them to force a tax-avoiding sale of YPI shares, and that the grace period effected by section 897 would

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[25] We think this timing factor gives credence to the representation in the administrative record that the exchange in question had solely a business, and not a tax-avoidance, purpose. See *supra* note 15.

give the Canadian YPL shareholders a motive to see YPI sold prior to the override date in order to avoid a U.S. tax. We think respondent is grasping at straws in an effort to persuade us to hold that tax avoidance was one of the principal purposes of the exchange involved herein. The fact of the matter is that the petitioners are four unrelated persons. Their common interest was to stay in the oil and gas business, an interest which would have been subverted, if not defeated, by a sale of the YPI shares. As far as the Canadian shareholders of YPL were concerned, any tangential incentive to avoid a future U.S. tax was clearly subordinated to the necessity of compliance with the restrictions imposed by Canadian law on the sale of the YPI shares by YPL. Moreover, any doubts relating to the significance of any tax-avoidance purpose during the section 897 grace period[26] are further minimized by the offer of a closing agreement by petitioners—a matter to which we now turn our attention in connection with respondent's attempt to equate deferral of tax with avoidance of tax.

Respondent argues that the deferral component of petitioners' transaction warrants his adverse determination. As respondent puts it, "In modern tax parlance, a tax deferred is a tax saved." In fact, given petitioners' willingness to enter into a closing agreement to recognize any inherent gain on an eventual sale of the YPI shares not otherwise recognized prior to the expiration of the grace period,[27] it would seem that it is only the deferral of taxation that respondent can be arguing as the present tax avoidance in this case.[28] The problem, however, with equating deferral with section 367 avoidance is that every transaction that qualifies for a section 367 ruling request is a nonrecognition transaction. By definition, income

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[26] In light of our decision that the sec. 897 argument must fail due to petitioners' substantial business purpose, we need not decide the claim by petitioners that respondent has the burden of proof as to this alleged "new matter." We note, however, that the transaction in issue added no incremental incentive to disinvest to that which already existed for the Canadian shareholders. Sec. 897 will require recognition of gains and losses by both foreign corporations and nonresident aliens after the override date.

[27] In this connection, we note that at the time the closing agreement was offered, petitioners considered that the grace period expired on Dec. 31, 1984, a position with which the respondent agreed. See *supra* note 21.

[28] In other words, when taxpayers set up a transaction under which there is a possibility that tax on the gain represented by shares of stock will be escaped entirely, this can be characterized as potential tax avoidance. However, when those taxpayers agree to recognize this gain to the extent it remains unrecognized upon the disposition of the shares, the only issue is the deferral of payment of the tax.

tax is deferred when a transaction qualifies as a nonrecognition incorporation, reorganization, or liquidation, until the stock or assets involved are transferred in a recognition transaction. Thus, if deferral alone were enough, there could never be a favorable ruling under section 367—a result that Congress obviously did not intend. See generally Aidinoff & Mosley, "Section 367(a)—Janus Revisited," 36 Tax Law. 629, 640, 655 (1983).[29] Certainly, the Commissioner has a legitimate interest in taxpayers' deferrals of taxes (see Sitrick, "Section 367 and Tax Avoidance: An Analysis of the Section 367 Guidelines," 25 Tax L. Rev. 429, 432 (1970)), but deferral, alone, cannot be equated with avoidance under section 367.

Respondent's all-or-nothing approach to proposed closing agreements—noted in *Kaiser Aluminum & Chemical Corp. v. Commissioner*, 76 T.C. 325, 349–351 (1981), and apparently still followed today (see H. Rept. 98–432 (Part 2) 1311 (1984); 61 J. Taxation 268, 269 (1984))—is no less unreasonable on the facts of the instant case than it was in *Kaiser Aluminum*. Where adoption of a proposed closing agreement would reduce the tax-avoidance possibilities to the level of those that would exist in any *domestic* incorporation transaction (i.e., deferral), respondent's refusal to enter the agreement or even to negotiate it is an element that ought to be considered in determining the reasonableness of his determination that avoidance of Federal income taxes was one of the principal purposes of the transaction. In light of Congress' approval in 1976 of a standard that permits nonrecognition treatment of transfers of liquid or passive investment assets outside the United States when the tax on the potential earnings from these assets "is paid *or is preserved for future payment*" (1975 House Report, *supra*, 1976–3 C.B. (Vol. 2) at 932; 1976 Senate Report, *supra*, 1976–3 C.B. (Vol. 3) at 300 (emphasis added); see also H. Rept. 98–432 (Part 2), *supra* at 1316 (generally reapproving this standard)), respondent's arguments about the enforceability and allegedly undue flexibility of closing agreements are simply unpersuasive. See *Kaiser Aluminum & Chemical Corp. v. Commissioner*, *supra* at 349–350. Indeed, we note that the policing difficulties

[29] Another way to understand this point is that sec. 367 was enacted to restrict only the incremental tax avoidance possible due to the limits of the U.S. taxing jurisdiction. Decisions about deferring taxes when assets are incorporated—in this country or abroad—were made in enacting sec. 351.

to which respondent points in connection with the proposed closing agreement with respect to a transfer of YPI stock by YPL taking place before the override date seem to be no different from those which will exist after the grace period contained in section 897 expires.[30]

Because the administrative record fails to disclose substantial evidence of a principal purpose of tax avoidance, either in the way of potential avoidance or tax deferral, we conclude that respondent's adverse determination is unreasonable within the meaning of section 7477(a)(2)(A) and that YPL will thus qualify for corporate status under section 367.

An appropriate decision will be entered.

STEVAN DUROVIC, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 1579–65, 4976–67, 3335–70, 6872–71. Filed January 28, 1985.

In 1954 through 1959, P and his brother were members of a partnership engaged in the business of distributing and selling a drug called Krebiozen. Thereafter, P, alone, carried on the business. *Held;*

1. The amounts of the items to be included in the cost of goods sold for the partnership determined.

2. The exchange rate to be used in converting those amounts into dollars determined.

3. P is not liable for an addition to tax for failure to file timely declarations of estimated tax for the taxable year 1954 under sec. 294(d)(1)(A), I.R.C. 1939.

4. Additions to tax for underpayment of estimated tax for the taxable years 1955 through 1958 under sec. 6654, I.R.C. 1954, sustained.

5. P is not liable for additions to tax for fraud for the taxable years 1954 through 1959 under sec. 6653(b), I.R.C. 1954.

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[30] For possible monitoring provisions which might be in a closing agreement, see Aidinoff & Mosley, "Section 367(a)—Janus Revisited," 36 Tax Law. 629, 648 & n. 91 (1983). In light of the dispute as to the expiration date of the grace period (see *supra* note 21), and our reluctance independently to articulate terms and conditions (*Dittler Bros., Inc. v. Commissioner*, 72 T.C. 896, 919–920 (1979), affd. without published opinion 642 F.2d 1211 (5th Cir. 1981)), we think it would be inappropriate to require petitioners to implement their offer of a closing agreement. Cf. *Hershey Foods Corp. v. Commissioner*, 76 T.C. 312, 324–325 (1981).

6. Sanctions imposed under Rule 104, Tax Court Rules of Practice and Procedure.

Leslie R. Bishop and *Leonard S. DeFranco*, for the petitioner.

Bryan R. Sullivan, for the respondent.

SIMPSON, *Judge*: The Commissioner determined the following deficiencies in, and additions to, the petitioner's Federal income taxes:

			Additions to tax		
Docket No.	*Year*	*Deficiency*	*Sec. 294(d)(1)(A), I.R.C. 1939*	*Sec. 6653(b), I.R.C. 1954*[1]	*Sec. 6654, I.R.C. 1954*
1579–65	1954	$27,878.07	$2,568.73	$13,939.04	- - -
	1955	55,627.76	- - -	27,813.88	$1,554.05
	1956	34,686.53	- - -	17,343.27	967.69
	1957	84,498.51	- - -	42,249.26	2,362.02
	1958	64,535.04	- - -	32,267.52	1,803.01
6872–71	1959	101,646.22	- - -	50,823.11	- - -
	1960	318,643.33	- - -	159,321.67	- - -
	1961	403,705.48	- - -	201,960.74	- - -
	1962	305,501.02	- - -	152,750.51	- - -
4976–67	1963	346,444.85	- - -	173,222.43	- - -
3335–70	1964	184,501.13	- - -	93,808.81	- - -

After concessions, the issues for decision are: (1) The determination of the amounts of the items to be included in the cost of goods sold for a partnership engaged in the business of distributing and selling a drug called Krebiozen and the foreign exchange rate to be applied to such amounts; (2) whether the petitioner is liable for additions to tax for failure to file timely declarations of estimated tax for the taxable year 1954 under section 294(d)(1)(A) of the Internal Revenue Code of 1939 and for underpayment of estimated tax for the taxable years 1955 through 1958 under section 6654; and (3) whether the petitioner is liable for additions to tax for fraud under section 6653(b) for the taxable years 1954 through 1959.

[1] All statutory references are to the Internal Revenue Code of 1954 as in effect during the years in issue, unless otherwise indicated.

FINDINGS OF FACT

Some of the facts have been stipulated, and those facts are so found.

The petitioner, Stevan Durovic, was born in Yugoslavia in 1905. He was a resident of Chicago, Illinois, at the time he filed his petition in docket No. 1579–65. He was a resident of Switzerland at the time he filed his petitions in docket Nos. 4976–67, 3335–70, and 6872–71. The petitioner did not file individual Federal income tax returns for 1954, 1955, 1956, 1957, and 1958. He filed individual Federal income tax returns with the Internal Revenue Service for 1959 through 1964.

The petitioner was an equal partner with his brother, Marko Durovic (Marko), in Duga Laboratories (Duga). The petitioner was a medical doctor, and Marko was a lawyer. They both lived in Argentina in the 1940's; the petitioner came to the United States in 1949, and Marko in 1950. While the petitioner lived in Argentina, he developed the drugs known as Kositerin and Krebiozen. He claimed that Kositerin was helpful in the treatment of hypertension and Krebiozen was helpful in the treatment of cancer. The partnership, Duga, was formed in the United States to distribute and sell Krebiozen.

Duga filed partnership returns for each of the years 1954 through 1959, which reported the amounts shown on page 105 for gross receipts, cost of goods sold, gross profit (loss), expense deductions, ordinary net income (loss), and partners' distributive shares of ordinary net income (loss).

The cost of goods sold reported on Duga's partnership returns for 1954 through 1958, and part of the cost of goods sold reported on its partnership return for 1959, were based on accumulated costs apportioned to the original supply of 200,000 ampules (original supply) of the drug Krebiozen. The ampules were distributed as follows:

Noncommercial	
(Distributed without charge or withheld for experimental programs, 1949 to April 1954)	63,903

Commercial		
1954		
1955	17,752	
1956	[2]30,977	
1957	23,715	
1958	33,357	
1959	24,381	
	5,915	136,097
		200,000

The costs apportioned to the ampules distributed from the original supply were based on the following cost accumulations:

Kositerin - 72,200 ampules at 17.565	[3]M$N 1,268,193
Krebiozen - 200,000 ampules at 15.025	3,005,000
Additional Argentine expenses (not explained)[4]	6,800
Total Argentine cost (rounded to nearest M$N 100)	4,280,000
Converted into dollars ($1 U.S. = M$N 3.36, the "official" rate of exchange	$1,273,809.50
Additional U.S. expenses—1949 to April 1951	52,202.15
Total costs to nearest $100 (used for cost of goods sold for 1954)	1,326,000.00
Additional U.S. costs—May 1951 through April 1954	78,511.33
Total costs (used for cost of goods sold for 1955 through 1959)	1,404,511.33

Duga apportioned the costs accumulations only over the 136,097 ampules from the original supply that were distributed commercially. The per-ampule cost was determined as follows:

(a) 1954: $\frac{\$1,326,000}{136,097} = \$9.74$

(b) 1955 through 1959: $\frac{\$1,404,511}{136,097} = \$10.32$

[2] In *Durovic v. Commissioner*, 54 T.C. 1364 (1970), affd. in part, revd. in part, and remanded 487 F.2d 36 (7th Cir. 1973), on remand 65 T.C. 480 (1975), affd. 542 F.2d 1328 (7th Cir. 1976), the Court found as a fact that 30,674 ampules were commercially distributed in 1955, 23,733 in 1956, and 33,722 in 1957. The figures for the number of ampules distributed commercially in 1955, 1956, and 1957 set out in our findings of fact were taken from the petitioner's accountant's work papers.

[3] Argentine pesos as designated by the symbol M$N.

[4] See *Durovic v. Commissioner*, 54 T.C. 1364, 1377, 1395 (1970).

	1954	1955	1956	1957	1958	1959
Gross receipts	$149,694.10	$205,936.73	$171,926.98	$263,336.53	$217,213.36	$325,896.53
Less: Cost of goods sold	172,957.74	319,682.64	244,738.80	344,244.24	251,611.92	83,064.80
Gross profit (loss)	(23,263.64)	(113,745.91)	(72,811.82)	(80,907.71)	(34,398.56)	242,831.73
Less: Expense deductions	43,960.57	30,161.10	48,110.23	21,851.67	20,741.41	23,536.96
Ordinary net income (loss)	(67,224.21)	(143,907.01)	(120,922.05)	(102,759.38)	(55,139.97)	219,294.77
Partners' share of ordinary net income (loss):						
(a) Marko	(33,612.10)	(71,953.50)	(60,461.02)	(51,379.69)	(27,569.98)	109,647.39
(b) Petitioner	(33,612.11)	(71,953.51)	(60,461.03)	(51,379.69)	(27,569.98)	109,647.38

As a result of the cost apportionments, the cost of goods sold figures on Duga's returns for 1954 through 1958 were as follows:

	Number of ampules ×	*per ampule cost* =	*Cost of goods sold*
1954	17,752	$9.74	[*]$172,957.74
1955	30,977	10.32	319,682.64
1956	23,715	10.32	244,738.80
1957	33,357	10.32	344,244.24
1958	24,381	10.32	251,611.92

Duga's reported cost of goods sold for 1959 was based on the following computation:

Source	*Number of ampules* ×	*per ampule cost* =	*Cost of goods sold*
Canada	10,000	0	0
Original supply	5,915	$10.32	$61,042.80
New production	21,175	1.04	22,022.00
1959 Cost of goods sold			83,064.80

In December 1959, the petitioner and Marko terminated Duga. In the latter part of 1959 or the early part of 1960, the petitioner formed a sole proprietorship, Promak Laboratories (Promak), and continued to sell Krebiozen.

The petitioner reported his Promak operations on a Schedule C. His returns reported the following amounts for total receipts, cost of goods sold, gross profit, other business deductions, and net profit (loss):

	1960	*1961*	*1962*	*1963*	*1964*
Total receipts	$442,676.10	$535,494.51	$438,731.69	$481,964.16	$346,792.75
Less: Cost of goods sold	23,571.78	11,415.55	14,600.35	13,104.50	15,183.60
Gross profit	419,104.32	524,078.96	424,131.34	468,859.66	331,609.15
Less: Other business deductions	399,012.48	449,018.80	460,673.52	403,180.70	302,402.12
Net profit (loss)	20,091.84	75,060.16	(36,542.18)	65,678.96	29,207.03

The petitioner's amended 1962 return reported additional development and representation expenses of $17,011.25, which

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[*]The cost of goods sold figure for 1954 is slightly higher than the product of 17,752 times $9.74, $172,904.48. This difference was observed but not explained in Marko's case. See *Durovic v. Commissioner*, 54 T.C. 1364, 1380 (1970).

increased other business deductions and increased the reported net loss by like amounts.

On his U.S. individual income tax return for 1959, the petitioner reported his distributive share of income from Duga. His individual returns for 1959 through 1964 applied and deducted net operating loss carryforward deductions in the following manner:

	1959	*1960*	*1961*	*1962*	*1963*	*1964*
From Duga						
1954	($33,612.10)	. . .	. . .	. . .	. . .	. . .
1955	(71,953.50)	. . .	. . .	. . .	. . .	. . .
1956	(4,081.79)	($20,091.84)	($36,287.39)	. . .	. . .	. . .
1957	. . .	. . .	(38,772.77)	. . .	. . .	. . .
1958	. . .	. . .	. . .	. . .	($27,569.98)	. . .
From Promak						
1962 (amended return)	. . .	. . .	. . .	. . .	(38,108.98)	($15,444.45)
	(109,647.39)	(20,091.84)	(75,060.16)	. . .	(65,678.96)	(15,444.45)

The other business deductions included on Schedule C of the petitioner's returns for 1960 through 1964 included the following expenses:

	1960	*1961*	*1962*	*1963*	*1964*
Interest	$59,336.00	. . .	. . .	. . .	. . .
Development and representation	300,222.50	$389,000	$408,891.65	$345,000	$240,000

The interest expense and $300,000 of the development and representation expense claimed on the petitioner's return for 1960 was based on the petitioner's claimed payments to Armando Ferrari, a resident of Argentina. The payments related to a service contract supposedly executed by the petitioner and Mr. Ferrari on December 31, 1951. The contract provided that Mr. Ferrari was to obtain licenses, organize meetings to study the drug, publish the results thereof, and advertise the drug. In return, Mr. Ferrari would receive $30,000 per year, payable when Krebiozen was sold or when the petitioner was able to pay.

On his original return for 1962, the petitioner claimed development and representation expenses of $391,880.40, $391,000 of which was based on claimed payments of research and development expenses incurred in connection with a contract between the petitioner and Mr. Ferrari. On his

amended return for 1962, the petitioner claimed additional development and representation expenses of $17,011.25, which were based on alleged payments to Mr. Ferrari for outside help and research and development of Krebiozen.

On his 1963 return, the petitioner claimed development and representation expenses of $345,000, $306,000 of which was based on claimed payments to Mr. Ferrari and $39,000 of which was based on claimed payments to Professor M.T. Marzoratti.

Sometime during the summer of 1963, the Commissioner opened a joint investigation into the petitioner's returns for 1961 and 1962. Special Agent William Mannie and Revenue Agent Sanford Schwartz were assigned to the investigation. The investigation later was expanded to include the petitioner's tax years 1954 through 1960 and 1963. During the investigation, the petitioner did not produce any records to substantiate the cost of goods sold claimed on Duga's returns for 1954 through 1959 or for the development and representation expenses claimed on his returns for 1960 through 1963.

The criminal investigation culminated in a recommendation that the petitioner be prosecuted for evading his income taxes. By letter dated May 28, 1965, Frank C. Conley, Regional Counsel, advised the petitioner's attorneys that the criminal case against the petitioner had been referred to the Department of Justice. Sometime during February 1966, the petitioner left the United States. On March 10, 1966, the petitioner was indicted for willfully attempting to evade his income taxes for the years 1960, 1961, and 1962. The petitioner has lived in Switzerland since at least May 1967. He has never returned to the United States to face the charges set forth in the criminal tax indictment.

In his notices of deficiency, the Commissioner recomputed the income of Duga and reduced its cost of goods sold for 1954 through 1959. As a result of such adjustments, he increased the petitioner's distributable income from Duga each year. He also disallowed a net operating loss carryover claimed in 1959. For the years 1960 through 1964, the Commissioner disallowed most of the deductions for development and representation expense and the net operating loss carryover to such years. The Commissioner also disallowed an interest deduction claimed in 1960. He increased the petitioner's income by

including certain unreported interest income in 1961 and 1962. For 1954, the Commissioner determined an addition to tax for failure to file timely a declaration of estimated tax under section 294(d)(1)(A) of the Internal Revenue Code of 1939, and for each of the years 1955 through 1958, he determined that the petitioner was liable for the addition to tax under section 6654 for underpayment of individual estimated income tax. The Commissioner determined that the petitioner was liable for the addition to tax for fraud under section 6653(b) for each of the years 1954 through 1964. Finally, the Commissioner determined that the petitioner was liable for the self-employment tax for the years 1954 through 1958 and 1962.

On June 17, 1982, the Commissioner served interrogatories and a request for production of documents on the petitioner's counsel. Such interrogatories sought information with respect to, among other things, costs incurred in research and development of Kositerin and Krebiozen, costs entering into cost of goods sold reported on Duga's returns for 1954 through 1959, expenses claimed as development and representation expenses on the petitioner's returns for 1960 through 1964, services rendered by Mr. Ferrari and ultimate disposition of funds allegedly paid to him, and loans to the petitioner and Marko. The request for production of documents asked for production of all business and bank records of the petitioner and Marko for 1940 to 1970.

On August 30, 1982, the Commissioner filed with the Court a motion to require the petitioner to provide his written consent to disclosure of bank records. Such motion asked the Court to compel the petitioner to provide his written consent to Swiss Credit Bank (Swiss Credit) to disclose bank records of his account. On August 31, 1982, the Commissioner filed a motion to compel the petitioner to respond to the discovery requests. The petitioner claimed his Fifth Amendment privilege in refusing to respond to the interrogatories and the request for production of documents. After oral argument on the motions, we, by order dated October 26, 1982, found, among other things, that the petitioner was entitled to claim the privilege against self-incrimination. We deferred action on the interrogatories. In accordance with our direction, the Commissioner revised his request for documents. Thereafter, we ordered

enforcement of the revised documents request on the ground that the records described therein were not covered by the Fifth Amendment privilege. We also ordered the petitioner to provide his consent by November 30, 1982, to Swiss Credit for the disclosure of bank records from 1959 through 1965. Finally, the order required the Commissioner to produce records in his possession after the petitioner complied with the order. In light of our ruling that the petitioner was entitled to claim the privilege against self-incrimination, the Commissioner did not continue to seek enforcement of the interrogatories. In response to that part of the October 26 order which compelled the production of documents described therein, the petitioner took the position that he did not have any records when he left the United States, and that he neither had any of the records nor knew of the existence or location of such records.

The petitioner did not provide his consent to Swiss Credit by the due date, November 30, 1982, and thereafter, the Commissioner moved to impose sanctions. The reasons given by the petitioner for his failure to give the consent were that issuance of a consent might not result in the production of documents and might violate a tax treaty between the United States and Switzerland. At the hearing held on January 26, 1983, we found that the petitioner's reasons did not constitute grounds for not providing the consent, but we gave the petitioner a second chance to comply with the October 26 order, allowing him to do so by February 16, 1983.

By letter dated February 10, 1983, the petitioner's counsel transmitted to the Court a copy of a purported letter from Swiss Credit to the petitioner, dated February 9, 1983, which stated that records for the period from January 1, 1959, through December 31, 1965, had been destroyed. In such letter, the petitioner's counsel stated that providing a consent would not result in production of records, but if it was necessary to deliver a consent, one would be prepared.

The Commissioner's counsel telephoned Briscoe Smith, an attorney representing Swiss Credit in New York. The Commissioner's counsel asked Mr. Smith to have Swiss Credit confirm that it had issued the letter dated February 9, 1983. Several days thereafter, Mr. Smith advised the Commissioner's counsel that Swiss Credit would not directly confirm that it issued

the letter, but would provide certified exemplars of the signatures appearing on the letter. On or about February 18, 1983, the Commissioner's counsel advised the petitioner's counsel that he wanted the petitioner to issue the consent.

On March 1, 1983, during a telephone call with counsel for both parties, we indicated that we would impose sanctions requested by the Commissioner, since the petitioner had not provided his consent. We pointed out to the counsel that even if Dr. Durovic gave his consent thereafter, it would be too late for the Commissioner to take up the matter with Swiss Credit and to prepare the case for trial. By letter dated March 14, 1983, the petitioner's counsel transmitted to the Court a letter dated March 9, 1983, in which the petitioner gave the required consent to Swiss Credit. By letter dated March 29, 1983, the petitioner's counsel advised the court that, contrary to the positions earlier taken, the petitioner had in fact provided his consent to Swiss Credit in January 1983.

By order dated April 4, 1983, we ordered that the Commissioner's oral motion requesting the imposition of sanctions be granted, and as sanctions, we thereby deemed established the following:

(a) The petitioner received for his own use and benefit all items claimed as development and representation expenses on his returns for 1960 ($300,222.50), 1961 ($389,000.00), 1962 ($391,880.40), 1963 ($345,000.00), and 1964 ($240,000.00) and interest expenses on his return for 1960 ($59,336.00); the petitioner on his return was not entitled to deduct any of those expenses; the expense deductions resulted in underpayments of tax; and the petitioner fraudulently, and with intent to evade tax, claimed those expenses on his returns; and

(b) The petitioner earned unreported taxable interest income in 1961 ($8,842.57) and 1962 ($10,280.00) from accounts and investments at the Royal Bank of Canada; the petitioner's failure to report the interest income resulted in an underpayment of tax; and the petitioner fraudulently, and with intent to evade tax, failed to report the interest income on his returns.

OPINION

The first issue for decision involves the determination of the cost of goods sold by Duga for the years 1954 through 1959. To decide that issue, we must determine the costs properly allocable to the acquisition of 200,000 ampules of Krebiozen (the original supply), and then, we must decide on the foreign exchange rate applicable to such costs to convert them into

dollars. These matters were considered and decided in protracted litigation in the case of *Durovic v. Commissioner*, 54 T.C. 1364 (1970), affd. in part, revd. in part, and remanded 487 F.2d 36 (7th Cir. 1973), on remand 65 T.C. 480 (1975), affd. 542 F.2d 1328 (7th Cir. 1976). However, in the present case, each party is asking us to reconsider some of the conclusions reached in that litigation. In *Durovic*, we found that in January 1950, Marko purchased the raw material for the original supply of Krebiozen from Juan Manuel Tanoira for M$N 3,005,000. We found that Marko borrowed M$N 2 million from Armando Ferrari to pay Mr. Tanoira. The Commissioner vigorously disputes those conclusions, and he presented new evidence to support his position.

In January 1959, the petitioner and Marko withdrew funds from the account of Duga and from their personal accounts in Chicago banks and transferred such funds to the Royal Bank of Canada (Royal Bank). Such funds totaled $362,104.25. At about the same time, gold bars were purchased in approximately the same amount and deposited in approximately equal amounts in two accounts, one in Marko and Olga's name, and one in the petitioner's name. The gold bars were withdrawn in June 1961.

The petitioner opened a bank account at the Royal Bank in December 1960, and he maintained an account at Swiss Credit, Zurich, Switzerland. On December 20, 1960, the petitioner wrote at least four checks to Mr. Ferrari, three of them in the amount of $50,000 each and one in the amount of $59,336. On December 22, 1960, $359,336 was credited to Mr. Ferrari's account at the Royal Bank. On the same day, $353,946 was withdrawn from that account and credited to the petitioner's account at the Royal Bank. The address for Mr. Ferrari's account was originally 900 Lakeshore Drive, Chicago, Illinois, which was the petitioner's address, but the address for the account was changed to Sarmiento No. 355, Buenos Aires, Argentina.

In May 1961, $179,895.68 was credited to the petitioner's account at the Royal Bank. In October 1961, Promak issued seven checks payable to the Royal Bank, and the petitioner withdrew $52,000 from his personal account in a Chicago bank. All the Promak checks and the petitioner's check, totaling $441,000, were deposited in the petitioner's account at

the Royal Bank. In April 1962, the petitioner withdrew $1 million from his account at the Royal Bank and invested that amount in ten $100,000 deposit receipts at the same bank. However, by the end of the month, he liquidated such investment. The petitioner signed a receipt dated December 3, 1963, for 10 checks in favor of Swiss Credit for $100,000 each, but the receipt bore the notation "File April 26/62."

In 1962, Promak transferred $391,000 to Swiss Credit. On the worksheets of the petitioner's accountant, such checks were listed as part of Promak's research and development expenses. In a letter dated April 26, 1963, to his accounting firm, the petitioner stated that the payments to Swiss Credit in the amount of $391,000 were payments for research and development of Krebiozen incurred in accordance with a contract between the petitioner and Mr. Ferrari. In a letter to his accounting firm dated May 14, 1964, the petitioner stated that $306,000 in payments were made by Promak to Swiss Credit for research and development expenses incurred in accordance with a contract between the petitioner and Mr. Ferrari. In the same letter, the petitioner stated that he personally paid $39,000 in December 1963 to Prof. M.T. Marzoratti for research and development in connection with Krebiozen.

From May through November 1964, the petitioner purchased $449,000 worth of deposit receipts at the Royal Bank. During the same period, he withdrew $211,000, leaving $238,000 in deposit receipts as of November 1964.

The Commissioner also presented evidence showing inconsistent statements by Mr. Ferrari as to the reasons for the payments to him. An agent of the IRS first interviewed Mr. Ferrari in 1964, and at that time, Mr. Ferrari stated that he loaned $300,000 to the petitioner in 1949 or 1950. He emphatically declared that he never rendered any services for the petitioner, and said that he understood that the 1951 contract was merely to evidence the loan. However, when the agent interviewed him again in 1965, Mr. Ferrari stated that he had worked on behalf of the petitioner, distributing literature to doctors in South America and attempting to secure licenses. He claimed that the $350,000 deposited in his account at the Royal Bank was in payment for his services. He also reiterated that he had loaned money to the petitioner and declared that

the funds deposited in his account at Swiss Credit were in payment of that loan.

The Commissioner called the special agent who had conducted an investigation of the Durovics for the purpose of showing that the Durovics and their representatives had made inconsistent statements concerning the availability of the records relating to the costs of Krebiozen and Kositerin. In *Durovic*, the Court found as a fact that all the business records relating to the costs incurred by the Durovics in Argentina in the production of Krebiozin and Kositerin were lost in the mail in 1956. However, the special agent testified that a representative of the Durovics told him in 1964 that such records could be secured from Argentina in 3 days. The representative also told the agent that the Durovics had furnished the Commissioner with such records in 1951. In response to the Commissioner's request for the production of documents in 1982, the petitioner declared that he had no such records, but within a month before the trial, he produced an alleged contract with Maria Teresa P. de Marzoratti purportedly executed in Argentina in 1949 calling for her to perform research for him.

The Commissioner argues that this new evidence undermines the basis for the Court's findings in *Durovic*. He maintains that such evidence casts substantial doubt on the Court's findings that Marko had purchased Krebiozen from Mr. Tanoira and that he had borrowed M$N 2 million from Mr. Ferrari to finance such purchase. The Commissioner suggests that the transfers of funds from the United States to Canada and to Switzerland evidence a scheme of concealment. He urges that such transfers, together with the inconsistent statements by Mr. Ferrari, indicate that the Court should not have believed Marko when he claimed to have borrowed the money from Mr. Ferrari. The Commissioner suggests that the funds allegedly transferred to Mr. Ferrari may not have actually left the petitioner's control, that there is substantial doubt as to whether any payments to Mr. Ferrari were for services or in repayment of a loan, and that in any event, Mr. Ferrari apparently cooperated with the petitioner to serve as a front man in the petitioner's plan of concealment. Because of the sanctions imposed on the petitioner for his failure to comply with the Court's order, we are not concerned with the establishment of the facts in 1960 through 1964. Yet, the

Commissioner vigorously contends that the petitioner's obvious plan of concealment and the repeated inconsistent statements by him and his representatives should be considered by us and should convince us not to accept the Court's earlier findings with respect to the cost of goods sold.

In speaking of its task, the Court observed in *Durovic* (54 T.C. at 1393):

> The record of this case exceeds 1,300 pages. In addition, both parties have benefited us with scores of exhibits and interrogatories. Notwithstanding this mass of evidentiary matter, the picture we have before us of the events which comprise this case is blurred and cracked with age. In some instances witnesses were called upon to reconstruct with clarity events which occurred more than a quarter of a century ago. The uncertain narrative occasioned by the dimmed memories of these individuals only served to compound with inconsistency a case which would have been difficult to try under the most favorable of circumstances. Nevertheless, we have attempted in our findings of fact to weigh all such inconsistencies, and to arrive at a fair and rational narration of the events which occurred herein. * * *

In his brief, the petitioner sought to defend his position by invoking the doctrine of collateral estoppel. However, he had not pleaded such doctrine, and consequently, he cannot rely upon it. See *Barber-Greene Americas, Inc. v. Commissioner*, 35 T.C. 365, 390 (1960); *Isenbergh v. Commissioner*, 31 T.C. 1046, 1057 (1959); *Wentworth Manufacturing Co. v. Commissioner*, 6 T.C. 1201, 1208 (1946). Under such circumstances, our decision must be governed by the principle of stare decisis. Although two cases may involve substantially the same facts, under the principle of stare decisis, the same result is not compelled where there are material factual differences. *Jefferson v. Commissioner*, 50 T.C. 963, 967 (1968); *Golden Rule Church Association v. Commissioner*, 41 T.C. 719, 730–731 (1964); *Rowan v. Commissioner*, 22 T.C. 865, 872 (1954).

By now, another decade has passed, and we have more exhibits and more testimony. Nevertheless, the record remains unclear. The events in 1960 and subsequently have only a remote connection with the acquisition of Krebiozen in 1950. These events do raise many questions, and they do serve to cast some doubt on Marko's account of the circumstances surrounding the acquisition of Krebiozen. Yet, the Court carefully weighed all the evidence presented to it in *Durovic*, and although the new evidence does raise some additional

questions, it is not sufficient to convince us that there is a material difference in this case that should lead us to a different conclusion.

The Commissioner contends that the uncertainties are largely due to the petitioner's failure to produce evidence and to his claim of the Fifth Amendment. Yet, we concluded that he has a right to claim the Fifth Amendment. We have imposed, admittedly severe, sanctions for the petitioner's failure to comply with the order of the Court, and we believe that such sanctions adequately deal with the petitioner's failure to produce evidence. After a review of the Commissioner's arguments and new evidence, we have decided that the petitioner may properly include in the cost of goods sold: the M$N 3,005,000 paid by Marko to Mr. Tanoira for the original supply of Krebiozen and $105,387.38 in additional U.S. expenses.[6]

Nor are we convinced by the petitioner's attempt to have us reconsider our earlier conclusion with respect to the foreign exchange rate to be used in computing the cost of goods sold for Duga. That subject was extensively considered by this Court in its opinions and by the Seventh Circuit in its opinions. After extensive exploration of this issue, it was held that the free rate should be used for such purposes. Although the petitioner has requested that we reconsider such conclusion, he has given us no sufficient basis in fact or law for reaching a different conclusion, and consequently, we will adhere to the earlier conclusion.

Since we have rejected both the Commissioner's and the petitioner's requests to reconsider the basic conclusions of the Court in *Durovic*, it follows that the findings of the Court in that case, as modified in our findings of fact, will be applied to determine the cost of goods sold by Duga for the years 1954 through 1959 in the present case.[7] As a result of such

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[6] In the present case, the Commissioner has conceded that the partnership may properly deduct $105,387.38 in additional U.S. expenses, the amount allowed by the Court in Marko's case. See *Durovic v. Commissioner*, 487 F.2d 36, 43 (7th Cir. 1973), on remand 65 T.C. 480, 482 (1975), affd. 542 F.2d 1328 (7th Cir. 1976). The petitioner has not argued that we should allow him more than that amount.

[7] The petitioner has not argued against and has conceded the following: (1) The accumulated costs of Krebiozen do not include any Kositerin costs or additional Argentine costs. See *Durovic v. Commissioner*, 54 T.C. 1384, 1395–1397 (1970). (2) The accumulated costs should be allocated over the 200,000 ampules and not just the 136,097 ampules commercially distributed. See *Durovic v. Commissioner*, 54 T.C. at 1394. (3) Costs allocated to the free distribution of 63,903 ampules of

conclusion, whether the petitioner is entitled to any carryover of a net operating loss for 1959 or 1960 will be determined in the parties' computations under Rule 155, Tax Court Rules of Practice and Procedure.[8]

The next issue for decision is whether the petitioner is liable for additions to tax for failure to file timely declarations of estimated tax for the taxable year 1954 under section 294(d)(1)(A) of the Internal Revenue Code of 1939 and for underpayment of estimated tax for the taxable years 1955 through 1958 under section 6654.

In *Durovic v. Commissioner, supra*, the Court held that Marko was not liable for the addition to tax for 1954 under section 294(d)(1)(A), I.R.C. 1939. The Court found that he had relied on the tax expertise of his accountant, Harry Grauer, and that such reliance was reasonable since Marko, to the Court's knowledge, had not, prior to 1954, had occasion to file returns for U.S. income.

In the present case, the Commissioner argues that the petitioner knew that the cost of goods sold figure supplied to Mr. Grauer was false and that, accordingly, the petitioner cannot show reasonable cause to excuse his failure to file timely declarations of estimated tax for 1954. However, we have not been convinced by the Commissioner that we should reconsider our conclusions in the earlier case. We believe that the factors cited by the Court in Marko's case to establish reasonable cause are equally applicable to the petitioner. Accordingly, we hold that the petitioner is not liable for any addition to tax for failure to file timely declarations of estimated tax for 1954 under section 294(d)(1)(A), I.R.C. 1939.

The additions to tax for underpayment of estimated tax for 1955 through 1958 are governed by section 6654. Unlike section 294(d)(1)(A), I.R.C. 1939, section 6654 has no provision relating to reasonable cause and lack of willful neglect; it is mandatory, and extenuating circumstances are irrelevant. *Durovic v. Commissioner*, 54 T.C. at 1400. In the present case, the petitioner has not shown that he is entitled to application

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Krebiozen cannot be amortized or otherwise deducted during 1954 through 1959. See *Durovic v. Commissioner*, 54 T.C. 1364, 1394 (1970), affd. in part, revd. in part, and remanded 487 F.2d 36, 44 (7th Cir. 1973), on remand 65 T.C. 480, 498–506 (1975), affd. 542 F.2d 1328, 1334 (7th Cir. 1976). (4) The petitioner is not entitled to any deduction during 1954 through 1964 for any loans from Ada Bossard von Martini. See *Durovic v. Commissioner*, 54 T.C. at 1368–1372, 1396–1397.

[8] Any reference to a Rule is to the Tax Court Rules of Practice and Procedure.

of any of the exceptions to section 6654. Accordingly, we hold that the petitioner is liable for the addition to tax under section 6654 for 1955 through 1958. *Grosshandler v. Commissioner*, 75 T.C. 1, 20–21 (1980); *Ruben v. Commissioner*, 33 T.C. 1071, 1072 (1960).

Now we reach the issue of fraud. Our review of the Commissioner's new evidence and our refusal to reach different conclusions with respect to the cost of goods sold for Duga are dispositive of the issue. In *Durovic*, the Court held that the Commissioner had failed to prove fraud on behalf of Marko. In the present case, we also believe and hold that the Commissioner has failed to prove fraud on behalf of the petitioner for the years 1954 through 1959.

The effects of our order imposing sanctions on the petitioner for his failure to comply with the Court's order with respect to Swiss Credit are to sustain the deficiencies determined by the Commissioner for 1960 through 1964 and to sustain the additions to tax for fraud determined by him for such years.[9] The petitioner requests that we reconsider such order.

The petitioner argues that for us to deem fraudulent intent established is an anomaly and represents a unique precedent. However, we did not merely deem fraudulent intent established; rather, as a sanction for the petitioner's failure to comply with our prior order, we deemed established certain facts. The Commissioner has the burden of proving fraud by clear and convincing evidence, and he may carry his burden by relying on facts deemed established by reason of a Court order. *Rechtzigel v. Commissioner*, 79 T.C. 132, 139–143 (1982), affd. per curiam on another issue 703 F.2d 1063 (8th Cir. 1983); *Marcus v. Commissioner*, 70 T.C. 562, 571–573 (1978), affd. without published opinion 621 F.2d 439 (5th Cir. 1980). The facts which we have deemed established are sufficient for the Commissioner to carry his burden of proof and to show that there was a fraudulent underpayment of taxes by the petitioner.

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[9] In his petition, the petitioner raised the statute of limitations as a bar to the determination and assessment of a deficiency for 1964. In our order dated Apr. 4, 1983, we deemed established the fact that the petitioner fraudulently, and with intent to evade tax, claimed development and representation expenses of $240,000 for 1964 which resulted in an underpayment of tax for that year. Accordingly, the statute of limitations remains open under sec. 6501(c)(1) and it does not bar the determination and assessment of a deficiency for 1964. *Estate of Temple v. Commissioner*, 67 T.C. 143, 159–160 (1976); *Harper v. Commissioner*, 54 T.C. 1121, 1142 (1970).

Where, as in the present case, there is a willful failure to comply with an order of this Court, we may impose appropriate sanctions including deeming established facts sufficient to show fraud. Admittedly, the sanctions are severe, but we concluded that they were necessary and appropriate under the circumstances. We have here a case involving extensive, stale evidence, and many of the events and transactions occurred outside the United States. As a result, proof is difficult at best. Our objective was to provide both parties with a fair opportunity for a trial, and to do so, we felt compelled to exercise to the utmost and with vigor the powers of the Court to compel the production of needed evidence.

At times, the petitioner sought to explain his failure to comply by claiming that the consent would be ineffective or that the bank records were no longer in existence. We made clear to him through his counsel that those were not sufficient reasons for not complying with our order. It was not up to him to decide whether the consent would be effective or whether the bank could find the necessary records; he was told, clearly and unequivocally, to give his written consent. With that written consent in hand, the Commissioner could then have sought to secure the production of records. He could contact the bank, and he could work through the Swiss Government. He might have powers unavailable to an ordinary person. See *Ryan v. Commissioner*, 58 T.C. 107 (1972). In any event, whether the Commissioner would ultimately be successful was not before us at the time of the order. There was no showing that it would be unlawful for the petitioner to give his consent. *United States v. Vetco, Inc.*, 644 F.2d 1324, 1332 (9th Cir. 1981); *First National City Bank of New York v. Internal Revenue Service*, 271 F.2d 616, 619–620 (2d Cir. 1959). Because of the severity of the requested sanctions, we explained these matters to the petitioner through his counsel on several occasions and made clear that all he was expected to do was give his written consent—a simple act—and that the failure to give such consent would constitute a violation of our order. By March 1, 1983, only a little more than a month before the trial, he had refused to give such consent, and consequently, we concluded that it was then too late for the consent to be of any use—if the consent was given after that date, the Commissioner would not have sufficient time to take the matter up with

the Swiss bank and the Swiss Government to find out what records could have been secured. Though the sanction is severe, the petitioner had ample opportunities to comply with the Court's order and to avoid the sanctions. Under the circumstances, we remain of the opinion that the sanctions are appropriate.[10]

Decisions will be entered under Rule 155.

CARL HERMAN AND HARRIETT HERMAN, ET AL.,[1] PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 344–82, 345–82, 347–82, 450–82, 709–82, 715–82, 746–82, 751–82, 1753–82, 2019–82, 2597–82, 9154–82, 9161–82, 14689–82. Filed January 30, 1985.

Due to the high cost and unavailability of medical malpractice insurance, a physician-owned insurance company known as the Medical Inter-Insurance Exchange of New Jersey (Exchange) was formed in 1976. In order to provide a surplus of funds, physicians or their professional corporations (P.C.'s) provided initial funding. A subordinated loan certificate (SLC) was issued by the Exchange in the name of individual physicians in return for these payments. The SLC would be redeemed by the Exchange when the physician ceased practicing medicine in

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[10] In his brief, the Commissioner requests that we modify the sanctions we imposed and allow the petitioner $222.50 in 1960 and $880.40 in 1962 as development and representation expenses since the Commissioner did not disallow such amounts in his notice of deficiency. For such reasons, we modify our prior sanctions and hold that such deductions shall be allowed in computing the decision under Rule 155.

[1] Cases of the following petitioners are consolidated herewith: Peter J. Guthorn and Katherine T. Guthorn, docket No. 345–82; Robert A. Heitner and Elizabeth Heitner, docket No. 347–82; William J. Esposito and Marie Esposito, docket No. 450–82; Richard Jacobs and Sheila J. Jacobs, docket No. 709–82; John J. Keyser and Anne M. Keyser, docket No. 715–82; Steven Lefrak and Phyllis Lefrak, docket No. 746–82; Nayan Kothari and Grace Kothari, docket No. 751–82; Nayan Kothari, M.D., P.A., docket No. 1753–82; Bernard Ehrenberg and Betty Ehrenberg, docket No. 2019–82; Joseph Marchesano and Catherine Marchesano, docket No. 2597–82; Estate of Nathaniel R. Avella, Deceased, Carolyn D. Avella and Charles J. Clarke, Jr., Executors, and Carolyn D. Avella, docket No. 9154–82; Ho-Haiung Chang and Yei-Er-Kao Chang, docket No. 9161–82; and Alden Hall and Audrey Hall, docket No. 14689–82.

New Jersey. Where a P.C. paid for the SLC on behalf of the shareholder/employee or nonshareholder/employee, there was an agreement that the physician would repay the P.C. upon redemption of the SLC.

Some of the petitioners deducted the cost of the SLC. Respondent disallowed the claimed deduction as not qualifying as an ordinary business expense. Respondent also determined that petitioner/physicians received a constructive dividend or additional compensation as shareholder/employees, or nonshareholder/employees, respectively, based on the purchase of the SLC by the P.C. *Held*, the cost of the SLC does not qualify as an ordinary business expense under sec. 162(a), I.R.C. 1954. *Held*, further, that the payment for the SLC by the P.C. does not constitute a dividend or additional income to the shareholder/employee or nonshareholder/employee, respectively.

Terence Heaney, for the petitioners.
William Halley and *Matthew Magnone*, for the respondent.

PANUTHOS, *Special Trial Judge*: These consolidated cases were heard pursuant to the provisions of section 7456(d)[2] and General Order No. 8 of this Court, 81 T.C. XXIII (1983).

Respondent issued statutory notices of deficiency in these consolidated cases which determined deficiencies in petitioners' 1977 Federal income taxes as follows:

Docket No.	*Deficiency*	*Docket No.*	*Deficiency*
344–82	$1,423.01	751–82	$2,954.00
345–82	3,979.23	1753–82[4]	529.80
347–82	1,385.95	2019–82	769.54
450–82	1,494.66	2597–82	1,388.36
709–82	4,648.57	9154–82	4,795.00
715–82[3]	2,786.19	9161–82	2,494.00
746–82	1,325.50	14689–82	2,415.00

Upon motion of the parties, the above cases were consolidated for purposes of trial, briefing, and opinion. These cases have been selected by the parties as representative of the various fact patterns involved in a substantial number of other cases.[5]

[2] All section references are to the Internal Revenue Code of 1954 as amended, unless otherwise indicated.

[3] On brief, respondent conceded to this case in full.

[4] Fiscal year ended June 30, 1978.

[5] There are in excess of 100 docketed cases where the parties have agreed to be bound by the Court's opinion in these consolidated cases.

Respondent determined the deficiencies in these cases based on the disallowance of a claimed deduction for the purchase of a subordinated loan certificate (hereinafter SLC); the inclusion of unreported dividend income of shareholder/employees; and the inclusion of unreported additional compensation in the income of shareholder/employees.[6] The dividend and additional compensation income determined by respondent is based on the purchase of an SLC by a professional corporation (hereinafter P.C.) and issued in the name of an individual physician.

The issues for decision are (1) whether payments by individual physicians or P.C.'s to purchase an SLC constitutes an ordinary and necessary business expense under section 162(a), or a capital expenditure; (2) whether payments for an SLC by a P.C. for its shareholder/employee physician constitute a dividend under section 301(a), section 301(c), and section 316(a); and (3) whether the purchase of an SLC by a P.C. for its nonshareholder/employee physician constitutes additional compensation under section 61.

Some of the facts in this case have been stipulated and are incorporated herein by this reference. At the time of filing the petition in this case, all of the petitioners were residents of New Jersey.[7]

FINDINGS OF FACT

1. Background

Because these are consolidated cases, there are several different factual patterns to address. We will begin by outlining the background upon which these various factual patterns must be superimposed.

During the 1970's, the cost of medical malpractice insurance in the State of New Jersey rose dramatically. By the mid-1970's, the continued existence of a private underwriter for medical malpractice insurance became increasingly uncertain. As of October 1976, the only insurers offering malpractice insurance to New Jersey physicians were two subsidiary

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[6] Respondent concedes with respect to Richard and Sheila Jacobs, docket No. 709-82, that constructive dividend treatment is only available to the extent of earnings and profits, making any excess distribution a return of capital.

[7] Petitioner Nayan Kothari, M.D., P.A., docket No. 1753-82, a professional corporation (P.C.) had its principal place of business in New Jersey.

insurance companies of Chubb & Son, Inc. (Chubb). As a result of this increasingly narrow market, the New Jersey legislature enacted chapter 30D, title XVII, Medical Malpractice Liability Insurance Act (N.J. Stat. Ann. sec. 17:30D, et seq. (West 1976)). Under the act, the commissioner of insurance of the State of New Jersey was empowered to activate a reinsurance association if he found that medical malpractice insurance was not readily available for any category or subcategory of insurance to which the act applied. In October of 1976, only one of the Chubb subsidiaries was offering medical malpractice insurance, generally, to all types of physicians in New Jersey. Sometime after October 1976, that subsidiary informed the commissioner of insurance that it intended to withdraw from providing medical malpractice insurance in New Jersey, effective February 1, 1977, unless the State activated the insurance provisions of the Medical Malpractice Liability Insurance Act.

The Medical Society of New Jersey was dissatisfied with the prospect of activation of the reinsurance association. Such dissatisfaction stemmed from several causes: (1) That the physicians would have little influence on the policy decisions and operations of the reinsurance association; (2) that they would not be represented as members of the governing body of such association; (3) that the reinsurance association would probably require higher premiums; (4) that excess losses would be assessable against the insured physicians; (5) that the reinsurance association would more deeply inject government into the affairs of New Jersey physicians; and (6) that there was no guarantee that physicians would not be charged a surplus contribution to provide for establishment of a recovery fund.

The principal concern among these was the assessable nature of the insurance policy that would be offered through the reinsurance association. An assessable policy is one in which, after losses have been determined at the end of the year, the insurance company has the right to assess, on a pro rata basis, all policyholders to make up for any net loss incurred during the previous insurance period. A nonassessable policy, on the other hand, is one in which a physician pays his policy premium, and thereafter cannot be assessed any additional amounts for the year to which those premiums apply. Thus, a nonassessable policy may cost more each year,

but will not cost more retroactively as a result of the claims history of the insured group of physicians during the term to which the original insurance policy applied.

The Medical Society decided that the formation of a physician-owned insurance carrier was the best means for providing malpractice insurance for physicians in New Jersey. Accordingly, in October of 1976, the Medical Society organized the Medical Inter-Insurance Exchange of New Jersey (hereinafter Exchange) as a physician-owned reciprocal inter-insurance exchange, under the provisions of chapter 50, title XVII of the New Jersey Statutes (N.J. Stat. Ann. sec. 17:50 (West 1976)).

The commissioner of insurance issued a permit to the Exchange to solicit insurance applications for organizational purposes. After obtaining the required number of applications for insurance, the Exchange was issued a certificate of authority from the commissioner of insurance.

Under New Jersey law, the Exchange was required to establish and maintain, as an asset, a surplus of cash and/or authorized securities of not less than the amount of the minimum capital and surplus required for a stock insurance company to write the same kind or kinds of insurance. Premiums or contributions to the Exchange, which was organized as an unincorporated association whose members are policyholders, were made by prospective members to provide a pool of assets from which claims against the members (to the extent covered by the contract of insurance) and the expenses of the Exchange are paid.[8] The Exchange issued only nonassessable policies. However, the Exchange could not begin to write nonassessable insurance policies until it had obtained an initial surplus of at least $750,000.

A physician becomes a member of the Exchange at such time as the Exchange issues an insurance policy to such physician. Membership automatically terminates upon expiration of the insurance policy. Thus, members of the Exchange are those physicians insured by the Exchange. Each member of the Exchange is entitled to one vote at all meetings of members. To be insured by the Exchange, a physician must be licensed to practice medicine in the State of New Jersey, must

[8]Because the Medical Inter-Insurance Exchange of New Jersey (Exchange) is currently an operating organization, we will use verbs in their present tense where appropriate.

have at least 75 percent of his practice therein, and must have an SLC issued in his or her name.

In order to provide the Exchange with surplus, and for the purpose of establishing a sound base to support the issuance of insurance policies, SLC's were issued. Any physician residing in New Jersey who wanted to purchase medical malpractice insurance from the Exchange was required, as a condition of obtaining such insurance, to purchase an SLC from the Exchange in an amount related to the speciality classification of his medical practice. The required amount to be paid for such a certificate ranged from $1,325 for low-risk classifications to $7,800 for high-risk classifications.[9] The certificates were issued for the sole purpose of providing surplus for the Exchange. They were not offered as an investment, they bore no interest, they contained a restrictive legend which made them nontransferable, and the holder of such certificate had no right to a redemption for the face value of the certificate. The certificates were exempt from registration under the Securities Exchange Act of 1933,[10] and under the New Jersey Uniform Securities Law.[11]

The certificates were issued only to, and in the names of, individual physicians who were prospective members of the Exchange. They were registered in the names of those individual physicians on the books of the Exchange. Because of the perceived need for a rapid solution to the lack of acceptable insurance coverage, and the filing, registration, and notice requirements under both Federal and State securities laws, no loan certificates were authorized to be issued to any partnership or corporation whose physicians were insured by the Exchange. The proceeds from the certificates were treated by the Exchange as surplus. Although segregated on its account books, funds received from the certificates and from insurance

[9]Nonresident physicians, although ineligible to purchase a subordinated loan certificate (SLC), were required to pay an initial nonrefundable premium surcharge in the same amount as the payment for an SLC required of resident physicians for the same speciality classification. Because all of the petitioners in these cases are residents of New Jersey or had their principal office located therein, we make no determination as to the treatment of payments made to the Exchange, by either an individual physician or a P.C., for nonresident physicians, as a basis for the provision of insurance.

[10]We assume the parties mean either the Securities Act of 1933, 48 Stat. 74, 15 U.S.C. sec. 77a, et seq., or the Securities Exchange Act of 1934, 48 Stat. 881, 15 U.S.C. sec. 78a, et seq.

[11]Uniform Securities Law (1967), N.J. Stat. Ann. sec. 49:3-47, et seq.

premium payments were commingled in the Exchange's bank accounts.

Upon issuance of the certificates, the Exchange intended to redeem them only in cases where the physician ceased practicing medicine in New Jersey, *and* was no longer insured by the Exchange. It was intended that the certificate would be redeemed only when the physician died, retired from the practice of medicine, or moved his practice out of the State of New Jersey. In the event that one of those conditions was satisfied, however, no guarantee was given that any or all of the principal amount of such certificate would be repaid.

In the event that the Exchange were liquidated, all of the assets of the Exchange, after payment of outstanding liabilities, including repayment of any outstanding SLC's, would be distributed to the persons who were members of the Exchange at the time of liquidation.

To date, all member physicians who subscribed for SLC's and who either died, retired from the practice of medicine in New Jersey, or moved their practice out of the State of New Jersey did, in fact, receive a repayment of the principal amounts of the SLC's. However, a physician changing to another insurer within the State of New Jersey would not be repaid the principal amount of his certificate at such time. Payments would only be made in this instance upon retirement, death, or movement of practice from New Jersey. At the time of trial, the Exchange insured approximately 7,000 physicians in New Jersey, which constituted approximately 64 percent of the total medical malpractice insurance market for the State.

In 1976, the Commissioner of Insurance of New Jersey activated the reinsurance provisions of the Medical Malpractice Liability Insurance Act with respect to medical malpractice insurance. One of the Chubb subsidiaries was to act as a "designated provider" of malpractice insurance and was 100-percent reinsured by the New Jersey Medical Malpractice Reinsurance Association pursuant to chapter 30D. Chubb, through its subsidiary, remained as a provider under the reinsurance provisions until it ceased to provide medical malpractice insurance in New Jersey in the spring of 1979. In 1978, the Medical Malpractice Liability Insurance Act was amended to allow the reinsurance association to directly write

medical malpractice insurance. Upon withdrawal of Chubb from the State, the reinsurance association began to directly write such insurance.

In the first year of operation, the premiums charged by the Exchange were the same as the premiums charged by the Chubb subsidiary acting as a 100-percent reinsured "designated provider" under the New Jersey State reinsurance provisions. At the time of trial, there were four carriers writing medical malpractice insurance in New Jersey. Of the four, the premiums charged by the Exchange were the highest across the board.

2. *Findings—Specific Petitioners*

These consolidated cases represent an effort to identify several fact patterns, each of which we will outline before determining the result of each case. Each of the relevant fact patterns is represented in the following chart:

Docket No.	Petitioners[1]	Percent shareholders	SLC cost deducted by PC	Repayment agreement: Oral	Written	No	Repayment[2] ever made
	Group I						
344-82	Carl and Harriet Herman	100	No	X			No
345-82	Peter J. and Katherine T. Guthorn	100	No		X		Yes - 12/5/80
2897-83	Joseph and Catherine Marchesano	100	Yes	X			No
	Group II						
751-83	Nayan and Grace Kothari	90/100	Yes	X			No
746-82	Steven and Phyllis Lefrak	80	Yes		X		No
14689-82	Alden and Audrey Hall	36	Yes	X			Repayment by estimate of Dr. Bruno Zanoski - 1978
347-82	Robert A. and Elizabeth Heitzer	25	No	X			No
709-83	Richard and Sheila Jacobs	28	No		X		No
450-82	William J. and Marie Esposito	16 2/3	Yes	X			Another shareholder repaid in 1978 - Dr. Robert Cavallino
9154-82	Estate of Nathaniel R. Avella, deceased, Carolyn D. Avella and Charles Clarke, Jr., executors, Carolyn Avella	14.23	Yes		X		Yes, by several physicians
	Group III						
715-83	John J. and Anne M. Kayser[3]	0	No	X			No
9161-82	Ho-Hsiung and Yei-Er-Kao Chang	0	Yes		X		No
	Group IV						
1753-82	Nayan Kothari, M.D., P.A.	N/A	Yes				No
2019-82	Bernard and Betty Ehrenberg	Sole proprietorship	Yes	N/A	N/A	N/A	No

[1]Underlining represents taxpayer-physicians. Spouses are listed because taxpayers filed joint returns.
[2]These physicians not having their respective corporations are still practicing medicine in New Jersey.
[3]Conceded in full by respondent.

The above chart breaks down the fact patterns in four basic groups: I. Physicians with a 100-percent interest; II. Physicians with a fractional interest; III. Physicians who had no equity interest in the P.C. and were employees; IV. A P.C. and a sole proprietorship. Within each of the first three groups there are two categories. Category I consists of those physicians whose P.C.'s deducted the cost of SLC's purchased in the name of a practicing physician. Category II physicians are those whose P.C.'s did not deduct the cost of the certificates.[12] Also within each of the first three groups, there are individual physicians who as either shareholder/employees or as nonshareholder/employees had one of the following: (1) A written agreement between the physician and P.C. that the physician would repay the P.C. upon redemption of the SLC by the Exchange, or (2) an oral agreement or understanding the terms of which are the same as in (1) above. In the fourth group, the P.C. and the sole proprietorship, the issue presented is the deductibility of the payment of the SLC.[13]

At trial, a number of physicians testified with respect to their particular factual pattern. Each also testified that without malpractice insurance, he or she would have significantly curtailed, or ceased altogether, his or her medical practice. In those cases where the cost of SLC's was not deducted, the SLC was listed as a corporate asset and described variously as "subordinated note," "deposits-insurance," or "medical malpractice deposit." In each of the cases where a deduction was claimed, it was treated as an insurance expense by the physician or his or her accountant. Each of the physicians had an employment agreement which, among other things, required the P.C. to pay for malpractice insurance. At trial, those physicians who did deduct the cost of the certificate testified that they regarded the purchase of the certificate as

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[12] In this latter category, the deficiency arose from respondent's inclusion of additional income to shareholder and nonshareholder/employees.

[13] The case of Nayan Kothari, M.D., P.A., docket No. 1753–82, involves a P.C.; the two shareholders who in combination own 100 percent of the P.C. are Nayan and Grace Kothari (husband and wife), petitioners in docket No. 751–82. There is no representative case involving a P.C. as a petitioner where a deduction for the purchase of an SLC on behalf of a nonshareholder/employee was disallowed.

Nevertheless, even though this issue does not arise from a viewpoint of the deduction by the P.C., we do have the issue relating to petitioners in group III as to whether the purchase of the SLC by the P.C. represents additional compensation to the nonshareholder/employee. Presumably, if the purchase of the SLC did represent compensation to the nonshareholder/employee, then the P.C. would be entitled to a deduction for compensation paid to its employee.

an additional cost of obtaining malpractice insurance. Thus, in their view, the certificate amounted to no more than an additional premium required of them prior to their being able to obtain insurance from the Exchange.[14]

OPINION

These cases present difficult and unique issues for determination. Respondent has determined that the payments made by the individual physicians to purchase the loan certificates constitute capital expenditures and are therefore not deductible as ordinary and necessary business expenses under section 162.[15] With respect to the nature of the expense for the loan certificate, petitioners are split; some of them treated the SLC's as a capital asset and recorded it as such on the corporate books; others treated the cost of the certificate as a currently deductible expense attributable to the purchase of medical malpractice insurance.

Respondent also determined that the purchase of an SLC by a P.C. for its shareholder/employees on the one hand, and for its non shareholder/employees on the other, constitutes, in the former case, a corporate distribution that is a dividend under section 301, and in the latter, additional compensation under section 61.[16]

Petitioners argue that the cost of the SLC constitutes an ordinary and necessary business expense under section 162 and is deductible in the year incurred. Petitioners' argument is based on the unavailability of medical malpractice insurance in New Jersey in 1977. With respect to respondent's argument with regard to the dividend and extra-compensation income issues, petitioners assert that the legal limitations

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[14] It should be noted that there is no dispute as to the deductibility of the annual premiums for medical malpractice insurance. The dispute relates to the initial payment for the (SLC). Respondent concedes that annual insurance premiums paid for policies issued in conjunction with the certificates are deductible.

[15] Note 14 *supra*.

[16] Respondent also suggests that with respect to those petitioners who have written agreements to repay the P.C. amounts received in redemption of the SLC, such amounts constitute an interest-free loan from the corporation to the employee for the period of time that the employee continues to hold the certificate. Respondent chose not to develop this argument. Additionally, neither respondent nor petitioners suggest that, to the extent the value of an SLC received by shareholder/employees did not correspond to their pro rata interest in the P.C., it was a dividend only to the extent of their interest with any remainder being additional compensation. See note 13 *supra*. Because of our decision in this case, we need not consider these questions further.

imposed on the Exchange by Federal and State security laws, in conjunction with the limited rights that attended ownership of an SLC, i.e., the right to buy an insurance policy, do not, in any meaningful sense, rise to the level of a constructive dividend or of additional compensation. We will address the issues in order.

1. Deductibility of Payment for Subordinated Loan Certificates

Initially, we must determine whether the P.C. is entitled under section 162 to deduct as a business expense the cost of purchasing the SLC. Whether or not an item is currently deductible turns on the facts of the case.

Section 162(a) provides that there will be allowed as a deduction all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. The question is essentially one of fact. *Walliser v. Commissioner*, 72 T.C. 433, 437 (1979); *Commissioner v. Heininger*, 320 U.S. 467, 475 (1943). Deductions are a matter of legislative grace. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934). Respondent's determinations are presumptively correct, and the burden of proof rests with petitioners. *Welch v. Helvering*, 290 U.S. 111, 115 (1933); Rule 142(a). The facts of this case lead to the conclusion that the cost of the SLC, while a necessary expense if the physicians were to obtain medical malpractice insurance, was not an ordinary expense within the meaning of section 162. *Boser v. Commissioner*, 77 T.C. 1124 (1981) (see also 79 T.C. II), affd. in an unpublished opinion (9th Cir., Dec. 22, 1983).

This Court has considered, on many occasions, whether or not an expense qualified as an ordinary and necessary business expense under section 162. See, e.g., *Jordan v. Commissioner*, 60 T.C. 770 (1973) (lobbying expense allowed); *Smith v. Commissioner*, 33 T.C. 861 (1960) (meal expense for guest but not taxpayer allowed); *Walliser v. Commissioner*, *supra* (traveling expense disallowed).[17] To qualify as an allowable deduction under section 162(a) an item must (1) be paid or incurred

[17] See generally *Bender v. Commissioner*, T.C. Memo. 1982-134; *Justice Steel, Inc. v. Commissioner*, T.C. Memo. 1980-466; *Brown v. Commissioner*, T.C. Memo. 1979-434; *Drury v. Commissioner*, T.C. Memo. 1977-199.

during the taxable year; (2) be for carrying on any trade or business; (3) be an expense; (4) be a necessary expense; and (5) be an ordinary expense. *Commissioner v. Lincoln Savings & Loan Association*, 403 U.S. 345, 352 (1971). It is clear from the facts of this case that petitioners have satisfied three of the five requirements for deductibility under section 162. There is no question that the payments were made during the taxable year to which they relate, and that they were made in carrying on a trade or business. Similarly, there is no disagreement as to the necessity of such payments. It is quite clear that without the payment, many, if not all, of the physicians would have ceased to practice medicine or significantly diminished their practice of medicine in the State of New Jersey. However, the facts of this case compel the conclusion that the payment for the SLC's was neither an "expense," nor an "ordinary" expense within the meaning of section 162(a). *Welch v. Helvering*, 290 U.S. 111 (1933).

As used in section 162, an "ordinary" expense has been defined as one which is "normal, usual, or customary" in the taxpayer's trade or business. *Boser v. Commissioner*, *supra* at 1132; *Deputy v. du Pont*, 308 U.S. 488, 494–495 (1940). In the present case, the facts do not support petitioners' position when the standard enunciated in *Boser v. Commissioner*, *supra*, is applied.

The crux of petitioners' argument is that the expense was ordinary because all physicians in the State of New Jersey were similarly situated, needed medical malpractice insurance, in large part purchased SLC's from the Exchange, and therefore the payment for the certificates became "ordinary." We disagree. We believe that the facts of this case effectively rebut petitioners' argument.

As the Supreme Court stated in *Commissioner v. Lincoln Savings & Loan Association*, *supra* at 354:

> What is important and controlling, we feel, is that the * * * payment serves to create or enhance for [the taxpayer] what is essentially a separate and distinct additional asset and that, as an inevitable consequence, the payment is capital in nature and not an expense, let alone an ordinary expense, deductible under section 162(a) in the absence of other factors not established here.

In the present case, payments made to the Exchange by individual physicians or their P.C.'s serve to provide the

capital basis upon which the insurance exchange could be formed. In exchange for the contributions of capital made to the Exchange by the physicians or their corporations, SLC's were issued in the names of individual physicians. Although not transferable nor immediately redeemable, it was the practice and intent of the Exchange to redeem these certificates upon the retirement, death, or departure from the State of New Jersey of the individual physicians. The Exchange identified the individual accounts of each certificate holder and, though it commingled its assets, was able to account for amounts paid in for the SLC's, on the one hand, and annual premium payments for medical malpractice insurance, on the other.

In the event that the exchange ceased to do business, after payments of liabilities to all creditors or other people with rights to its assets, and prior to payments of any remaining assets to the policy members who represented members of the Exchange, all outstanding SLC's would be repaid. The certificates were subordinated only as to other debts or other liabilities of the Exchange, but not to the interest of the member policyholders. Such prospective refund would be made on a pro rata basis to each of the certificate holders, based upon the respective amount of money paid for the certificate.

We also note that the structure of the Exchange was determined in part by the requirements of State and Federal security laws. The notes were issued in the form they were, and to the people to whom they were issued, because of the requirements and limitations of those laws. However, the fact remains that, in exchange for capital contributions, the Exchange issued loan certificates, subordinate only to other lienholders or creditors of the Exchange, and that these certificates would likely be redeemed at some future time. In fact, the certificates look more like securities, the cost of which is capital in nature and is not deductible, than like some additional insurance premium. *David R. Webb Co. V. Commissioner*, 77 T.C. 1134 (1981), affd. 708 F. 2d 1254 (7th Cir. 1983); *Firemen's Insurance Co. v. Commissioner*, 30 B.T.A. 1004 (1934).[18] The purchase of a certificate was an investment in a

[18] *Towne v. Commissioner*, T.C. Memo. 1977-356.

security which, it was hoped, would make possible a subsequent purchase of insurance.[19]

The Exchange was designed to provide a specific kind of insurance to a group of people in the State of New Jersey to make possible their practice of medicine. Sale of the certificates was needed to generate liquidity and availability of funds to satisfy claims against the member physicians. The issuance of the certificates is more like the sale and purchase of a capital asset than a deductible expense.[20] The fact that the physician had ongoing, annual insurance premium obligations to secure insurance coverage further buttresses this position. The annual insurance premiums were conceded as deductible by respondent.

Petitioners argue that they should be allowed to deduct the cost of the SLC's because there existed the possibility that they would not be redeemed. We do not find petitioners' argument compelling. This is so for several reasons: (1) All investments are at risk, and it is always possible that a note, a bond, or a stock issue could cease to be of value; (2) it was the intent and practice of the Exchange to pay the face value of any certificate upon the happening of one of the required precedent events; and (3) every physician who had satisfied one of those precedent conditions had in fact been repaid the face value of the certificates. Each of these factors, by itself and together, helps to outline the nature and characteristics of the certificates. The certificates are essentially a separate and distinct additional asset. *Commissioner v. Lincoln Savings & Loan Association, supra* at 354.

The certificates have the characteristics of both equity and debt. For example, they make it possible for those certificate holders who choose to purchase a policy, to participate in the management of the Exchange. Although they do not provide a return in the form of dividends or interest, they have been redeemed at face value and, barring any diminishing of the Exchange's assets, would be redeemed at face value at some time in the future. Thus, they look like debt instruments, at least with regard to their being redeemed at face value, but

[19] See, e.g., *Fitch v. Commissioner*, T.C. Memo. 1975-36; *Oster v. Commissioner*, T.C. Memo. 1964-335.

[20] The appropriate time for deduction of the cost of a certificate, if ever, would be when the Exchange refused to redeem it after satisfaction of the required conditions precedent.

like equity instruments with respect to the uncertainty of the date upon which they would be redeemed and the possibility of participating in the management of the Exchange.[21] It is, however, unnecessary for us to resolve the exact nature and characteristics of the instrument at issue. It is sufficient for us to decide, as we do, that the SLC's issued by the Exchange represent some kind of security instrument and that the purchase price for the certificates is not a currently deductible expense: the cost of the certificates represents the purchase of a capital asset with an indefinite useful life.

2. Recognition of Income by Employee

The remaining two issues for decision will be considered together. The question in each case is the effect on the shareholder/employee and nonshareholder/employee of the payment made by the P.C. to the Exchange for which an SLC was issued in the name of the individual physician. The question is whether or not, in the former case, the payment by the corporation for the certificate issued to the shareholder/employee constitutes a dividend within the meaning of section 301, and in the latter case, whether payment for the certificate constitutes additional compensation under section 61.

Respondent argues that any corporate distribution made to a shareholder is a dividend to the extent of the earnings and profits available for that purpose. Accordingly, respondent argues that the purchase of the SLC by the corporation and issued in the names of individual physicians constitutes a dividend with respect to those physicians who are shareholder/employees of the P.C. which paid for the certificates. With respect to the nonshareholder/employees of the P.C. in whose names the certificates were issued, respondent argues that payment for such certificates by the corporation constitutes additional compensation to the nonshareholder/employee.[22]

Petitioners, on the other hand, argue that the P.C.'s purchased the certificates for a substantial corporate purpose and that any personal benefit to shareholder or nonshareholder employees was incidental.

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[21] *Klein v. Commissioner*, 75 T.C. 298, 302 (1980); cf. *Frantz v. Commissioner*, 83 T.C. 162 (1984).
[22] See notes 13 & 16.

For the reasons outlined below, we agree that the purchase of the SLC's by the P.C. does not constitute a dividend or additional compensation to the individual physician in whose name the certificate was issued.

In our view, the correct result should characterize the purchase of the certificates at the corporate level. That characterization having been made, the appropriate characterization of the payment for the certificates at the individual level should follow clearly. From the corporate perspective, these transactions are identical. Irrespective of the individual to whom the certificate is ultimately issued, each individual is an employee of the corporation and, in order for each to perform the services for which the corporation employs him, each must be insured. Indeed, there is nothing in the record to suggest that, at least with respect to those employees who are shareholders, that the face amount of the certificate issued by the Exchange represented individual shareholder/employees' pro rata interests in the P.C. In our view, the corporation purchased assets necessary to make it possible for their employees to perform their duties. They neither made a distribution nor incurred additional expenses. Rather, they acquired additional capital assets with an indefinite useful life, the face amount of which, though held in the names of their employees, the P.C.'s were entitled to upon the happening of one of the precedent conditions.[23] At no time did any individual employee have any right to a cash redemption from the Exchange in the face amount of the note which was issued in his or her name. To find otherwise would be to elevate form over substance, something which, when concerned about an underlying reality, we will not do. *Benjamin v. Commissioner*, 66 T.C. 1084 (1976), aff'd. 592 F.2d 1259 (5th Cir. 1979); *Ruefenacht v. O'Halloran*, 737 F.2d 320, 337 (3d Cir. 1984); *Strick Corp. v. United States*, 714 F.2d 1194, 1206 (3d Cir. 1983).

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[23] Although not developed at trial, there is some question whether a P.C. could, upon departure of a physician, simply have the certificate reregistered in the name of a new physician employee of the corporation.

This view is buttressed by the fact that there was substantial testimony that each of the physicians had an agreement[24] with the various corporations that, in the event that one of the requisite precedents to payment of the face amount of the certificate were to occur, and the SLC were redeemed, the corporation would be repaid the face value of the certificate.[25] Though such testimony is arguably self-serving, we found the witnesses credible and forthright and accept their testimony on its face. Respondent presented no evidence to the contrary, nor did he suggest that such agreements were ineffective or otherwise illusory.[26] We find that each of the physicians had an agreement to repay his P.C. amounts paid to the physician by the Exchange in redemption of the certificate. Thus, whether a shareholder/employee or a nonshareholder/employee, no physician had an unconditional right to amounts paid upon redemption of the certificates; each was required to repay that money to the corporation. *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932). There is no doubt that the employees benefited by the purchase of these corporate assets; the purchase allowed each to perform his or her services as a physician, and in turn be paid a salary based upon his or her ability to perform. Such, however, is the case with many, if not all, corporate assets. The mere fact that a corporation purchases a security instrument to enable its employees to perform their work does not make those assets, or some measure of their value, dividends or additional compensation, as the case may be, to those employees working for the corporation.[27]

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[24] Oral promises of principals to pay appear to be outside the New Jersey Statute of Frauds, N.J. Stat. Ann. sec. 25:1, et seq. See also *Schoor Associates, Inc. v. Holmdel Heights Construction Co.*, 68 N.J. 95 (1975). In any event, because we consider the SLC's corporate assets, the form of an agreement to pay redeemed amounts to the P.C. is irrelevant.

[25] To the extent some of the petitioners did not testify, affidavits were submitted to the effect that they would have so testified. Respondent stipulated that they would testify to an agreement but withheld his right to object to the veracity of such testimony. At no time, however, did he make such an objection.

[26] See note 16.

[27] We need not determine at this time whether or not, upon terminating employment with a P.C., a shareholder or nonshareholder employee beginning a solo practice of medicine would have a taxable benefit, i.e., the use of a corporate asset (the certificate), making possible the purchase of malpractice insurance for the physician in his individual capacity. See note 23.

Decisions will be entered for the petitioners in docket Nos. 344-82, 345-82, 347-82, 450-82, 709-82, 715-82, 746-82, 751-82, 2597-82, 9161-82, and 14689-82.

Decisions will be entered for the respondent in docket Nos. 1753-82 and 2019-82.

Decision will be entered under Rule 155 in docket No. 9154-82.

ELANA T. McQUADE, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 22429-81. Filed January 31, 1985.

Held, under *Montana v. United States*, 440 U.S. 147 (1979), P is a party in the prior litigation with the United States. *Held, further*, R is collaterally estopped from determining Federal tax deficiencies against P for the years in dispute where a bankruptcy court, a court of competent jurisdiction, previously determined that P and her deceased husband owe no taxes for those years. *Held, further*, *United States v. Mendoza*, 464 U.S. 154 (1984), is not applicable to this situation in which prior litigation dealt with tax liability of P, her deceased husband, and his wholly owned corporation, for years before this Court. *Held, further*, since no genuine issue of material fact is before this Court, P's motion for summary judgment is granted.

Fred T. Witt, Jr., and *David W. Elrod*, for the petitioner.
Richard D. Ames and *Mark L. Puryear*, for the respondent.

OPINION

DAWSON, *Chief Judge*: Petitioner's motion for summary judgment was assigned to Special Trial Judge Francis J. Cantrel for hearing, consideration, and ruling thereon.[1] After a review of the record, we agree with and adopt his opinion, which is set forth below.

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[1] We need not determine at this time whether or not, upon terminating employment with a P.C., a shareholder or nonshareholder employee beginning a solo practice of medicine would have a taxable benefit, i.e., the use of a corporate asset (the certificate), making possible the purchase of malpractice insurance for the physician in his individual capacity. See note 23.

[1] This case was assigned pursuant to Delegation Order No. 8 of this Court, 81 T.C. XXV (1983).

OPINION OF THE SPECIAL TRIAL JUDGE

CANTREL, *Special Trial Judge*: This case is before the Court on petitioner's motion for summary judgment, filed on June 13, 1984, pursuant to Rule 121(a), Tax Court Rules of Practice and Procedure.[2]

Respondent issued a notice of deficiency to petitioner on May 28, 1981, in which he determined deficiencies in petitioner's Federal income tax and additions to the tax for the taxable calendar years 1976 and 1977 in the following respective amounts:

Years	*Income tax*	*Addition to tax, I.R.C. 1954 Sec. 6653(b)*
1976	$710,670.31	$377,610.15
1977	861,605.22	452,117.61

On the same day, respondent issued a joint notice of deficiency for the same years and in the exact same amounts to Estate of Joel H. McQuade, deceased, and Elana T. McQuade, executrix; Elana T. McQuade, surviving wife.

The above amounts were determined based on a sequence of events that began in 1974 when petitioner's husband Joel H. McQuade (hereinafter referred to as Joel or McQuade), Ray Acker (hereinafter referred to as Acker), a vice president at Southwestern Bell Telephone Co. responsible for leasing equipment for the company, and others organized a venture to share in fees, commissions, and profits to be made from certain leveraged lease transactions. In the transaction's most basic form, Acker would pass on to McQuade the leasing needs and requirements of Southwestern Bell, along with the amount of the low bid, so that McQuade could put in the lowest bid on behalf of the company he worked for, ITEL Corp.

For part of the time, McQuade was a partner in a partnership formed to carry on this venture. At some point in 1974 or 1975, McQuade began using his wholly owned corporation, Systems Financing, Inc. (hereinafter referred to as SFI), as part of the venture. The entire enterprise was structured so that on any equipment-leasing transaction on which the bid submitted to Southwestern Bell by McQuade for ITEL met the necessary criteria, McQuade and Acker would share various

[2] All Rule references are to the Tax Court Rules of Practice and Procedure.

profits and commissions. This scheme continued through 1977, during which time McQuade and SFI received their shares of profits and income.

Respondent determined in the notices of deficiency that the McQuades failed to report as income certain amounts received as a result of the venture as income, including income from kickbacks, salary from consulting fees, and capital gain from distributions from SFI, and McQuade's distributive share of partnership income arising out of the venture.

At some point prior to the issuance of the deficiency notices, McQuade and SFI filed for bankruptcy, i.e., for an arrangement under chapter 11. The Internal Revenue Service was the sole creditor. Also, on May 23, 1979, McQuade died leaving his wife as executrix of his estate.

On October 28, 1983, the Bankruptcy Court for the Northern District of Texas, Dallas division, entered findings of fact and conclusions of law in the case of *Systems Financing, Inc., and Joel Herndon McQuade v. Internal Revenue Service*, BK Nos. 3-79-0194-F & 3-79-0195-F (Bankr. N.D. Tex 1983). These findings were based on a trial, during which the United States introduced as evidence certain tax computations based on its income analysis for Elana T. McQuade (hereinafter referred to as Elana or petitioner) as well as for Joel. Both notices of deficiency were introduced as evidence, as were the joint Federal income tax returns for the McQuades for the years at issue here.

After setting out in detail the items of income, loss, deductions, and credits for the McQuades, as part of its findings of fact, the Bankruptcy Court found—

> 74. For the taxable year 1975, *the McQuades* has no federal income tax liability. * * *
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> 100. *The McQuades* had no taxable income in 1976 and, therefore, had no federal income tax liability in 1976. * * *
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> 122. *The McQuades* had no federal income tax liability for 1977.
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> 123. For the taxable years 1975, 1976 and 1977, respectively, the amounts listed for each item of income, gain, loss, deduction or credit of the McQuades and SFI in the schedules prepared by Mr. Dick Holmes and introduced at trial as Plaintiff's Exhibits 13 through 19 are true and correct. * * *
>
> [Emphasis added.]

The court reiterated in its conclusions of law that "4. *The McQuades* have no federal tax liability for the taxable years

1975, 1976 and 1977." (Emphasis added.) Thereupon the court entered an order on October 28, 1983, "that the claims of the Internal Revenue Service filed herein be disallowed." The determination of Joel's income tax liability for 1976 and 1977 was a necessary finding by the Bankruptcy Court. A fortiori, a determination on Elana's notice, identical in every respect with Joel's, must obtain the same result, i.e., that she likewise had no tax liability for 1976 and 1977.

The United States filed a notice of appeal from the judgment of the Bankruptcy Court on November 2, 1983. Subsequently, on January 2, 1984, the United States voluntarily moved to dismiss its appeal on the ground that "it has determined that no appeal should be taken in this matter."[3] The motion was granted, and the appeal was dismissed by order entered on February 1, 1984.

Thus, and both parties agree, the decision of the Bankruptcy Court is final for all purposes.

Petitioner subsequently filed her motion for summary judgment in this Court on the grounds of collateral estoppel, res judicata, and the contention that respondent has not shown that any genuine issue of material fact exists in this case.[4]

Petitioner asks us to determine that respondent is collaterally estopped from determining a deficiency against her for 1976 and 1977 because the Bankruptcy Court has already determined in a final, judicial proceeding that she and her deceased husband had no tax liability for those years. More specifically, we must decide whether petitioner Elana, who was not a named party in the bankruptcy proceeding, should nevertheless be considered bound by the proceeding because she was an interested party and directed the course of action of the suit. In support of her motion, petitioner argues that she was a real party in interest in the bankruptcy proceeding because she was named by respondent individually as surviving wife and as executrix in the notice of deficiency sent to McQuade's estate. She claims that the same issues of law and fact that are involved in the present case were adjudicated in the bankrupt-

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[3] Respondent has come forward with no other or more specific rationale for voluntarily dismissing the appeal in the bankruptcy case.

[4] Petitioner's prayer for costs and attorneys' fees pursuant to the Equal Access to Justice Act of 1980, Pub. L. 96-481, 94 Stat. 2321, 5 U.S.C. sec. 504 (1982 ed.), in her petition is not a part of this summary judgment motion. Petitioner must file a motion under Rule 231(a)(2) to claim reasonable litigation costs; thus, her prayer for costs and attorneys' fees are not a part of this case.

cy proceeding. Alternatively, petitioner argues that the judgment of the Bankruptcy Court is res judicata as to the present case because there exists sufficient identity of parties and issues.

Finally, petitioner contends she is entitled to summary judgment because no material facts are at issue here. She has set forth the facts as determined in the prior suit; respondent withdrew his appeal stating that no appeal should be taken; and respondent has not come forward with any facts to controvert the findings of the Bankruptcy Court.

Respondent, of course, argues that petitioner was not a party to the prior lawsuit and asks us to hold that, as such, she cannot use nonmutual offensive collateral estoppel to forestall respondent from obtaining his day in court with respect to her tax liabilities for the years in dispute. Respondent further claims, somewhat vaguely, that the thrust of a bankruptcy case, where a judge is trying to protect all creditors, especially small businesses, is different from a tax case. Thus, apparently, his contention is that the Tax Court should not allow petitioner to use the findings of the prior suit to collaterally estop respondent from determining deficiencies here. He also contends that his voluntary dismissal of the McQuade bankruptcy appeal should not be taken to mean that the appeal did not have merit.[5]

The general principle of res judicata provides that once a court of competent jurisdiction has entered a final judgment on the merits of a cause of action, the parties to the suit *and their privies* are bound as to each matter that sustained or defeated the claim, and as to any other admissible matter that could have been offered for that purpose. *Commissioner v. Sunnen*, 333 U.S. 591, 597 (1948).

Where the second action between the same parties is on a different claim, however, the judgment in the prior action operates as an estoppel as to those matters at issue or points controverted, and upon which the findings or verdict were rendered. *Commissioner v. Sunnen*, *supra* at 597–598. In other words, once a party has fought out a matter in litigation with

[5] Respondent's attempt to raise petitioner's Fifth Amendment right to due process is wholly meritless. Suffice it to say that he has no standing to do so. *Baker v. Carr*, 369 U.S. 186, 204–206 (1962).

the other party, "he cannot later renew that duel." *Commissioner v. Sunnen, supra.*

The Supreme Court further developed the rules for application of collateral estoppel in *Montana v. United States*, 440 U.S. 147 (1979). There, the Court held that the United States, which directed and financed the first litigation in State court, was collaterally estopped in a subsequent suit it, itself, filed in Federal court from disputing rights, issues, and facts previously determined by a court of competent jurisdiction. The Supreme Court held that where the United States, *even though not a (named) party to the prior suit*, has assumed sufficient control over the litigation, and has a sufficient and direct financial or proprietary interest in the outcome of the suit, then the principles of collateral estoppel should apply to the United States. *Montana v. United States, supra* at 153–154.

> the persons for whose benefit and at whose direction a cause of action is litigated cannot be said to be "strangers to the cause. * * * [O]ne who prosecutes or defends a suit in the name of another to establish and protect his own right, or who assists in the prosecution or defense of an action in aid of some interest of his own * * * is as much bound * * * as he would be if he had been a party to the record." * * * [*Montana v. United States, supra* at 154, citing *Souffront v. Compagnie des Sucreries*, 217 U.S. 475, 486–487 (1910).]

Whether a litigant has exercised control over the prior litigation is essentially a factual analysis. See *Montana v. United States, supra* at 155. In the present case, Elana, executrix of Joel's estate and clearly a person with a definite interest in the outcome of the bankruptcy proceeding, had a sufficient financial stake in the litigation for her not to be considered a "stranger to the cause." No evidence was introduced by either party here to elucidate the full extent of petitioner's participation in the bankruptcy suit, although her attorneys assert that she did take an active role. Respondent does not dispute this assertion nor does he argue that she was not actively involved. Nevertheless, the facts are clear and undisputed that the notice of deficiency respondent issued to petitioner and other evidence of her tax liability for the years at bar were introduced into evidence in the prior litigation, and the court made a determination of her income tax liabilities. Moreover, the fact remains that the same issues decided in the prior proceeding are those presented here.

In *Parklane Hosiery Co. v. Shore*, 439 U.S. 322 (1979), the Supreme Court distinguished the traditional difference between offensive use of collateral estoppel, where a plaintiff seeks to foreclose a defendant from raising an issue the defendant has previously litigated and lost, and its defensive use, where a defendant seeks to preclude a plaintiff from raising an issue the plaintiff has previously lost. The Court concluded that the offensive use of collateral estoppel should be allowed and that the trial courts should have "broad discretion" to determine when a party to the later suit could assert nonmutual offensive collateral estoppel against the other litigant, a party to a prior suit. *Parklane Hosiery Co. v. Shore, supra* at 331.[6]

The Court in *Parklane Hosiery*, however, concluded that certain circumstances might justify reluctance to allow the offensive use of collateral estoppel by a nonparty to the prior litigation; for example, where the plaintiff could easily have joined in the earlier action or the defendant in the first action might have had little incentive to mount a vigorous defense. But where none of these circumstances, nor other compelling reasons, are present, the purposes of collateral estoppel are met whether or not the party seeking to apply the principle was a litigant in the prior suit.

In a prior opinion involving these issues, *Graham v. Commissioner*, 76 T.C. 853 (1981), the taxpayer's former wife had transferred a secret formula to a corporation they controlled. We find that *Graham* is distinguishable from the instant case in that, here, petitioner in the prior bankruptcy litigation is to be construed a "party" in all but a technical sense. In *Graham*, the taxpayer and his former wife received royalties from the proceeds of sales of products using the formula. After respondent issued notices of deficiency jointly for certain years, and individually to the taxpayer and his former wife for later years, she paid the tax for 1 year and filed suit for refund in the U.S. District Court. That court held that the transaction was a sale of nondepreciable property. The Tax Court, in the taxpayer-husband's later suit, used the broad discretion

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[6] Collateral estoppel serves to "relieve parties of the cost and vexation of multiple lawsuits, conserve judicial resources, and, by preventing inconsistent decisions, encourage reliance on adjudication." *United States v. Mendoza*, 464 U.S. 154, 158 (1984), citing *Allen v. McCurry*, 449 U.S. 90, 94 (1980).

granted to trial courts by the Supreme Court in *Montana v. United States, supra*, and held that *Graham* was an appropriate case in which to collaterally estop respondent from asserting the same position he had held in the former wife's case. *Graham v. Commissioner, supra* at 858. The issues decided by the District Court were the same as would be decided by the Tax Court; the Government had had a full and fair opportunity to litigate its case before the District Court; and the taxpayer was not forum shopping. Since *Graham* is distinguishable from the present case, we leave for another day the effect, if any, of *United States v. Mendoza*, 464 U.S. 154, 157–158 (1984), on *Graham*.

Respondent strenuously argues that the instant case is controlled by *United States v. Mendoza, supra*, in which the Supreme Court held that under certain circumstances the United States cannot be collaterally estopped on an issue adjudicated against it in an earlier lawsuit brought by a different party. *United States v. Mendoza*, 464 U.S. at 155. For the reasons we now discuss, we find *Mendoza* to be inapplicable to the present situation.

In *Mendoza*, the Court dealt with an issue involving the constitutionality under the Nationality Act of 1940 of a decision to withdraw a naturalization examiner from the Philippines in 1945. The Court found that where the Government is litigating issues involving legal questions of substantial public importance, allowing nonmutual collateral estoppel against it could thwart the development of important questions of law by freezing the first final decision on a particular legal issue. *United States v. Mendoza, supra*. The Supreme Court held in *Mendoza* that the Government was not bound by a decision in a prior case that involved different litigants.[7] See and compare *United States v. Stauffer Chemical Co.*, 464 U.S. 165 (1984), in which the Supreme Court allowed the Stauffer company to assert collateral estoppel successfully against the United States in a later suit involving the issue of whether private contractors were authorized representatives under

[7] See and compare *Sun Towers, Inc. v. Heckler*, 725 F.2d 315 (5th Cir. 1984), in which the court held that *United States v. Mendoza, supra*, foreclosed the use of nonmutual collateral estoppel against the Secretary, Department of Health and Human Services, who had denied payment of certain costs claimed to be due under the Medicare Act. The court noted that the scope of the *Mendoza* decision was ambiguous, but found that *Mendoza* applied "to all issues." *Sun Towers, Inc. v. Heckler, supra* at 323 n. 8.

provisions of the Clean Air Act, Pub. L. 95–95, 91 Stat. 686, 42 U.S.C. sec. 7414(a)(2) (1976 and Supp. V 1981). The United States had already litigated the issue against one of the company's other plants in another location and lost. The Court called this principle "mutual defensive collateral estoppel," where "Like *Montana* the case at bar involves the defensive use of collateral estoppel against the government by a party to a prior action." *United States v. Stauffer Chemical Co.*, 464 U.S. at 170.

In *Mendoza*, the Court distinguished the different situation in *Montana v. United States, supra*, where the Government was bound by the prior decision because it had financed and controlled the first litigation; thus for all practical purposes, the United States had been a party in the first case. *United States v. Mendoza*, 464 U.S. at 159.

Here we have a situation similar to that in *Montana* where the unnamed party in the former suit was nevertheless an interested party, took part in the action, and was financially affected by the outcome. Thus, petitioner constituted a "party" in all but a technical sense. As a result, mutuality of parties exists sufficient to activate the principle of estoppel, so that petitioner is not attempting to use "nonmutual offensive collateral estoppel" against respondent.

The Bankruptcy Code, Pub. L. 95–598, 92 Stat. 2582, 11 U.S.C. sec. 505(a)(1) (1982 ed.), authorizes a bankruptcy court to "determine the amount or legality of any tax." This Court, in *Comas, Inc. v. Commissioner*, 23 T.C. 8, 12 (1954), has concluded that "Congress intended that once a bankruptcy court allowed a deficiency for which claim was filed and that court's action became final, the amount and validity of the deficiency was not thereafter to be the subject of a consideration by the Tax Court."[8]

The bankruptcy proceeding with which we are concerned determined the tax liability of the McQuades and of Joel's wholly owned corporation, SFI, for the same years now before this Court. Although the court did not have petitioner before it as a named party, the deficiencies determined against

[8] See also *Huckabee Auto Co. v. United States*, an unreported case (Bankr. M.D. Ga. 1984, 84–2 USTC par. 9841), where the Bankruptcy Court for the Middle District, Georgia, held that once a ch. 11 plan is confirmed by the court, the plan is binding on the United States and it may not attempt to collect the tax in another manner.

McQuade's estate named her as the executrix and surviving wife. The court also had before it the deficiency notice naming petitioner individually and other documents relating to petitioner's tax liability. Furthermore, the deficiencies determined against her here involve exactly the same issues that were decided in the bankruptcy proceeding, i.e., the income tax deficiencies and fraud additions to the tax arising from Joel's activities in the venture with Ray Acker and others in the lease transactions.

Because we decide that respondent is collaterally estopped from asserting the issues already decided by the Bankruptcy Court, a court of competent jurisdiction, we grant petitioner's motion for summary judgment. It cannot be legitimately disputed that she has no Federal income tax liability for the years 1976 and 1977, so there are no genuine issues as to any material facts remaining in this case.[9] Therefore,

An appropriate order and decision will be entered.

ESTATE OF WILLIAM A. LIDBURY, DECEASED, HARRY LIDBURY, EXECUTOR, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 4130–81, 4131–81. Filed February 4, 1985.

H and W owned real property as joint tenants with right of survivorship. In 1951, H and W executed a joint and mutual will devising the entire estate to the surviving spouse, with their children to inherit upon the death of the surviving spouse. W died in 1964, but the will was not filed or admitted to probate. *Held*: Under Illinois law, title to the real property held by H and W as joint tenants passed to H as survivor when W died, without restriction under the will. There was no gift to the children by H when W died.

H made gifts to his children, their spouses, and one grandchild in the taxable years 1973 through 1977. H died in 1977. *Held*,

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[9] There can be no valid contention that respondent's fraud allegations are still at issue. Suffice it to say that if there is no tax liability, and therefore no underpayment, there cannot be an addition to tax for fraud. See sec. 6653(b)(1).

gifts by H were not in contemplation of death under sec. 2035, I.R.C. 1954, and are not includable in H's gross estate.

Robert V. Lewis and *Earl T. Byron*, for the petitioner.
Victoria S. Crosley, for the respondent.

GOFFE, *Judge*: The Commissioner determined a deficiency in petitioner's Federal estate tax for the taxable year 1977 in the amount of $22,440, and a deficiency in petitioner's Federal gift tax for the taxable year 1964 in the amount of $15,327.33. An addition to tax under section 6651(a)[1] of $3,831.83 was also imposed. The issues for decision are: (1) Whether William A. Lidbury, deceased, made a taxable gift of an interest in real property upon the death of his wife in 1964; and (2) whether transfers made by William A. Lidbury, deceased, are includable in his gross estate as gifts made in contemplation of death under section 2035.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and accompanying exhibits are so found and incorporated herein by reference.

Harry Lidbury (Harry), is the executor of the will of his father, William A. Lidbury (Mr. Lidbury), who died on March 6, 1977, at the age of 89. Harry's residence was Sharon, Wisconsin, at the time that the petitions in these cases were filed. Mr. Lidbury, however, was a resident of the State of Illinois when he died.

Mr. Lidbury was born on March 27, 1887, and married Rose Lidbury (Mrs. Lidbury), who was born on August 17, 1892. The couple had four children, all of whom lived on and farmed land adjacent to or near their parents' farms until Mr. Lidbury's death:

Child's name	*Date of birth*	*Spouse's name*	*Offspring*
Frederick	Jan. 10, 1914	Lucille	Various
Harry	Jan. 31, 1915	Darlene	Julie
Pearl	Oct. 27, 1922	Francis Andersen	Various
Vernon	Aug. 2, 1927	Louise	Various

[1] All section references are to the Internal Revenue Code of 1954 and attendant regulations as amended and in effect for the relevant years, and all Rule references are to this Court's Rules of Practice and Procedure.

Mr. Lidbury was the fourth of five children. His two brothers, one of whom was still alive when Mr. Lidbury died, both died at the age of 89. His two sisters both predeceased Mr. Lidbury. Both died of mature-onset diabetes.

On October 3, 1951, Mr. and Mrs. Lidbury executed their last will and testament (the will). The terms of the will devised all of the couple's real and personal property to the surviving spouse, with the four children to inherit the entire estate upon the death of the surviving spouse. Pertinent portions of the will are:

> FOURTH: After the decease of both of us we and each of us do and does give, devise and bequeath all the estate which * * * either of us shall own or be entitled to at the time of the death of the survivor of us, both real and personal, of every nature and description and wheresoever situate, unto our four children * * *, share and share alike, for their own use forever.
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> * * * * * * *
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> SIXTH: We make this joint will in pursuance of a contract and agreement between us for the purpose of disposing of all of the property which we now own, or may hereafter acquire, either jointly or severally, in accordance with a general plan agreed upon between us. In making this, our Last Will and Testament we, and each of us, do covenant and agree that upon the death of one of us, the survivor will not in any manner directly or indirectly dispose of his or her property to the end that the general plan of distribution, as provided herein, shall be altered and changed in any form whatsoever; and we and each of us do further covenant and agree that the survivor of us shall hold and manage the property which he or she may own outright and of which he or she may have the use, by reason of this, our Last Will and Testament, in a careful and prudent manner, so as not to dissipate any of said property.

Mrs. Lidbury died on December 16, 1964. The will was never filed with the probate court nor admitted as Mrs. Lidbury's will, having been either overlooked or forgotten at the time of her death. The Federal estate tax return filed with respect to Mrs. Lidbury's estate was accepted by the Internal Revenue Service as filed. The estate, as reported on the return, consisted primarily of Mrs. Lidbury's one-half interest in property owned in joint tenancy with her husband. Mr. Lidbury did not file a Federal gift tax return for any quarter of the taxable year 1964.

Mr. and Mrs. Lidbury owned the following farms in Boone County, Illinois, at the time of Mrs. Lidbury's death, as joint tenants with right of survivorship:

Date of purchase	*Size of farm*	*Price*	*Form of ownership*
1937[2]	130 acres	$19,500	Joint tenancy
1930	40 acres	1,800	Joint tenancy
1952	40 acres	7,150	Joint tenancy
1955[3]	80 acres	19,800	Joint tenancy

The first three parcels of land were combined into one farm of 210 acres. Mr. and Mrs. Lidbury lived on the 80-acre farm at the time of Mrs. Lidbury's death in 1964. The Lidbury family, parents, children, and spouses, worked together on the two farms and the children's nearby farms in a cooperative fashion, without keeping accounts or paying each other for their labors. The Lidbury sons and son-in-law helped Mr. Lidbury plant, combine, and harvest crops without direct compensation other than reimbursement for out-of-pocket expenses. Mrs. Lidbury also contributed to the operations of the farm. Harry lived with his parents until he married at the age of 36, receiving only room, board, and pocket money.

On April 23, 1974, Mr. Lidbury began to see the first of several doctors for a prostate disorder. On May 5, 1974, Mr. Lidbury was admitted to Rockford Memorial Hospital where he underwent a transurethral prostatectomy. Mr. Lidbury's activities were restricted for approximately 2 months following the surgery, but by July 8, 1974, his condition had markedly improved. He was not informed at the time that he had possible cancer of the prostate, as the cancer was "Stage A" and considered clinically insignificant. Although he probably had mature-onset diabetes, the condition did not need treatment. Dr. Taylor, his primary doctor, considered Mr. Lidbury to be of generally good health at this time. Mr. Lidbury did have arthritis in his hands which made it necessary for him to hire his son, Frederick Lidbury, to act as his attorney in fact and write his checks.

After his wife died, Mr. Lidbury continued to live on the 80-acre farm until September 1974. From September 1974 through November 1975, Mr. Lidbury lived with his daughter Pearl whom he paid for room, board, and other care. During this period, Mr. Lidbury helped with the fall harvest in 1974, cut weeds and made minor repairs on the farms in the summer

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[2]This property was purchased by Mr. and Mrs. Lidbury in 1928, quit-claimed to Harry on Jan. 28, 1937, and quit-claimed from Harry back to them as joint tenants on that same date.

[3]This property was a replacement for a house purchased in 1951, and sold in 1955 for $22,000.

of 1975, and attended the 25th wedding anniversary party for Harry and his wife on August 5, 1975. He also gave $1,500 to each of his four children on December 18, 1974.

The 80-acre farm was sold on July 22, 1975, for $116,000. Mr. Lidbury gave a portion of the net proceeds to his children, their spouses, and one grandchild on August 13, 1975. Harry used the $9,000 given to him and his wife to partially pay for a combine. The $3,000 given by Mr. Lidbury to Harry's daughter Julie was used to help pay for her college education. Mr. Lidbury was pleased to see his granddaughter graduate from college as neither Mr. Lidbury nor his son Harry had gone to college. Mr. Lidbury appeared healthy and vital at a family party given only 8 days before these gifts, and expressed no concerns to Harry at that time about his medical problems or any particular expectation of death.

In October 1975, Mr. Lidbury was examined in preparation for his admission to Meadows Park Nursing Home in Clinton, Wisconsin, in November 1975. He was informed that he had cancer of the prostate, but was "mostly unconcerned" according to the medical reports. By the fall of 1975, Mr. Lidbury was largely confined to a wheelchair. He attended a family Christmas celebration in 1975. Shortly thereafter, on January 8, 1976, Mr. Lidbury gave $3,000 to each of his children and to each of their spouses.

On February 20, 1976, Mr. Lidbury entered Beloit Memorial Hospital where he underwent a biopsy of the prostate on March 4, 1976, and a bilateral orchidectomy on March 15, 1976. His general physical condition was gradually deteriorating at this time.

Mr. Lidbury died on March 6, 1977, of acute myocardial failure due to arteriosclerotic heart disease as a consequence of general and cerebral arteriosclerosis. His prostate problems were listed on the death certificate as a condition contributing to death, but not related to the cause.

During the period between April 1973 and his death, Mr. Lidbury made a number of gifts to his children, their spouses, and one grandchild. Mr. Lidbury filed a Federal gift tax return for the quarter ending on September 30, 1975, with respect to his gifts of August 13, 1975, and paid a gift tax in the amount of $1,256.06, after use of the specific exemption amount

available under section 2521,[4] and the $3,000 annual exclusion for each donee.[5] A lawyer prepared Mr. Lidbury's income tax returns and gift tax return. Neither the lawyer nor anyone else provided detailed advice to Mr. Lidbury on the reduction of his estate by the use of gifts.

The combined chronology of events is as follows:

Date	*Event*	*Total gift*
Apr. 1973	$8,185.85 gifts to each of four children	$32,743
Dec. 1973	$2,200 gifts to each of four children	8,800
Mar. 6, 1974	3 years before death	
Apr. 23, 1974	First doctor's visit related to prostate	
May 5, 1974	Prostate surgery at Rockford Memorial Hospital	
Dec. 18, 1974	$1,500 gifts to each of four children	6,000
July 22, 1975	Sale of 80-acre farm	
Aug. 13, 1975	$6,000 gifts to each of three children and to each of their spouses	36,000
	$4,500 gifts each to one child and that child's spouse	9,000
	$3,000 gift to one grandchild	3,000
Oct. 1975	Visit to doctor, told of prostate cancer	
Nov. 1975	Enters Meadows Park Nursing Home	
Jan. 8, 1976	$3,000 gifts to each of four children and to each of their spouses	24,000
Mar. 15, 1976	Prostate surgery at Beloit Memorial Hospital	
Jan. 6, 1977	$3,000 gifts to each of four children and to each of their spouses	24,000
Mar. 6, 1977	Death due to heart disease	

When Mr. Lidbury died, Harry filed the will for probate with the Circuit Court of the 17th Judicial Circuit, Boone County, Illinois. Harry, as executor of the estate, timely filed a Federal estate tax return which included the 210-acre farm as the major asset. The only heirs and beneficiaries under Mr. Lidbury's will were Mr. Lidbury's four children. Attached to the return was a statement listing the gifts of August 13, 1975,

[4]Sec. 2521 was repealed by the Tax Reform Act of 1976, Pub. L. 94-455, sec. 2001(b)(3), 90 Stat. 1520, 1849, effective for gifts made after Dec. 31, 1976.

[5]Taxable gifts in the taxable year 1973 totaled $41,543.40. Mr. Lidbury did not file a gift tax return in the taxable year 1973 as he believed that he could give up to $42,000 to his children without gift tax consequences by using the specific exemption of $30,000 and four annual exclusions of $3,000 each. After applying the exemption and exclusions to the gifts in the taxable year 1973, $456.60 of the specific exemption remained unused and was claimed on the quarterly gift tax return for the August 1975 gifts.

with a declaration that the motivation for the gifts was Mr. Lidbury's "desire to reward his children for what they had done for him in the past."

On December 4, 1980, the Commissioner timely issued two statutory notices of deficiency to petitioner, the first pertaining to estate taxes, the second pertaining to gift taxes. The Commissioner determined that the gifts made in December 1974, August 1975, and January 1976 were includable in the gross estate as gifts made in contemplation of death under section 2035, resulting in a deficiency of $22,440. The gifts made in 1973 and on January 6, 1977, are not at issue in the statutory notice. The Commissioner further determined that Mr. Lidbury made a gift of a remainder interest in the 290 acres of farm land to his four children on December 16, 1964, such interest having a fair market value of $99,058.72. This determination resulted in a deficiency of $15,327.33. An addition to tax for delinquency for failure to file a return under section 6651(a) of $3,831.83 was also imposed.[6]

The two cases, one for the determination of estate tax, the other for determination of gift tax, were consolidated for trial, briefing, and opinion by order dated November 28, 1983.

OPINION

The issues for decision are: (1) Whether William A. Lidbury, deceased, made a taxable gift of an interest in real property upon the death of his wife in 1964; and (2) whether transfers made by William A. Lidbury, deceased, are includable in his gross estate as gifts made in contemplation of death under section 2035.

Petitioner contends that the will was not a binding contract until filed for probate when Mr. Lidbury died, and that, therefore, nothing passed under the will until 1977. Alternatively, petitioner argues that, if the will was a binding contract by virtue of being a joint and mutual will, Mr. Lidbury received a life estate in his wife's half of the real property as consideration for the transfer of the remainder in his one-half interest to the children, to become effective upon his death. Further, under this alternative argument, only Mr. Lidbury's one-half of the real property should be included in his gross

[6]Respondent conceded the addition to tax on brief.

estate under section 2031, as the remainder interest in his wife's one-half of the real property passed to the children upon Mrs. Lidbury's death, and not through Mr. Lidbury's estate.

Respondent argues that Mrs. Lidbury's death created a contract under the will, binding Mr. Lidbury to convey all of the real property received by him as the surviving joint tenant and held by him as fee simple owner during his lifetime, to his children at his death, whether or not the document was filed for probate. Respondent thus contends that the gift consists of the present value at the time of Mrs. Lidbury's death of the children's contractual right to receive the entire property when Mr. Lidbury died, and respondent values this gift of a cause of action as equivalent to a remainder interest in the property. Respondent includes the entire value of the unsold joint tenancy property in Mr. Lidbury's estate.

The nature and extent of an interest or right to property is controlled by State law. *Aquilino v. United States*, 363 U.S. 509, 512–513 (1960); *Estate of Fulmer v. Commissioner*, 83 T.C. 302, 304 (1984). The determination of whether Mr. Lidbury made a gift to his children upon his wife's death, therefore, requires an analysis of Illinois law as it applies to real property held in joint tenancy, and to joint and mutual wills.

In Illinois, a joint tenancy is not severed by either the execution or probate of a joint and mutual will. *First United Presbyterian Church v. Christenson*, 64 Ill. 2d 491, 356 N.E.2d 532, 535 (1976). The title to the property held in joint tenancy automatically passes by operation of law to the survivor or survivors. *Klajbor v. Klajbor*, 406 Ill. 513, 94 N.E.2d 502 (1950). Mr. Lidbury, therefore, received his wife's one-half interest in their jointly held property when she died, as the surviving joint tenant, and not under the will.[7]

The issue, however, is whether the transformation of Mr. Lidbury's interest into a fee simple interest in the property was subject to a contract for disposition equivalent to a gift to

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[7]Despite the virtually parallel factual situations, this case is distinguishable from *Olson v. Reisimer*, 271 F.2d 623 (7th Cir. 1959). The court found that, under Wisconsin law, the joint and mutual will effected a severance of the joint tenancy when the wife died. Her one-half interest in the property was, therefore, devised to their child under the terms of the joint will, subject to a life estate in the husband, and was thus not taxable subsequently in the husband's estate. The husband's one-half interest was transferred upon the wife's death to their child, again subject to a life estate in the husband, and was included in his estate. The issue of a purported gift by the husband at the time of the wife's death was not raised.

his children. Real property held in joint tenancy can be the subject of a contractual agreement contained in a joint and mutual will, and a court of equity, under appropriate circumstances, will enforce the agreement and limit the surviving joint tenant's disposition of the property. *First United Presbyterian Church v. Christenson*, *supra* at 535. The devisees do not, however, acquire a remainder interest upon the death of the first spouse, but, instead, become third-party beneficiaries entitled to seek enforcement of the contract in equity. *Tontz v. Heath*, 20 Ill. 2d 286, 170 N.E.2d 153, 158 (1960).

A joint and mutual will is not automatically effective as a contract or a will. It is long-established law in Illinois that a will is not effective for any purpose until it is admitted to probate. *Crooker v. McArdle*, 332 Ill. 27, 163 N.E. 384, 385 (1928). This broad generalization negates the effect of the Lidburys' will as a will until admitted to probate upon Mr. Lidbury's death. It is still possible, however, that the will might, nonetheless, be a contract for testamentary disposition if it became an irrevocable contract when Mrs. Lidbury died.

A joint and mutual will, executed pursuant to an agreement not to revoke, is revocable at any time prior to death in any of the manners prescribed by statute. *In re Estate of Gaglione*, 97 Ill. 2d 408, 454 N.E.2d 664, 668 (1983); *In re Baughman's Estate*, 20 Ill. 2d 593, 170 N.E.2d 557, 562 (1960). Even a purportedly irrevocable joint and mutual will, whether or not probated at the death of the first spouse, may be revoked by the surviving spouse, and a later will may be admitted to probate. *In re Estate of Gaglione*, *supra*; *In re Briick's Estate*, 24 Ill. App. 2d 77, 164 N.E.2d 82 (1959). The prior will may create equitable claims against the estate, but such claims will not work to defeat the later will's admission to probate.

For such a will to become nominally irrevocable, the first spouse must die, and the testamentary disposition of the entire estate must be in pursuance of a contract or compact. A contract, in law or equity, limiting disposition will be found in a joint and mutual will only after an examination of the facts and circumstances surrounding, as well as the language of, the will. *In re Edwards' Estate*, 3 Ill. 2d 116, 120 N.E.2d 10 (1954). The joint and mutual will creates merely a presumption in favor of a contract between the parties who have executed the will, such contract to be established by clear, convincing, and

satisfying evidence. *Bonczkowski v. Kucharski*, 13 Ill. 2d 443, 150 N.E.2d 144, 150 (1958). A contract may be found when the spouses divide their estate among children of prior marriages, or where special circumstances demonstrate that other consideration creates a contractual obligation. *Tontz v. Heath*, *supra* at 158; *Bonczkowski v. Kurcharski*, *supra* at 150–151. The third-party beneficiaries of the original joint and mutual will, therefore, must prove that there was a contract to limit the disposition of the property, and that the contract was not revoked. *In re Baughman's Estate*, *supra*.

In this case, despite the use of the word "contract" in the will, the will merely devises the estate equally to the couple's children, in accord with the natural disposition of the property. The will, rather than being an important contract for disposition, was actually forgotten at the time of Mrs. Lidbury's death, and evidently ignored until Mr. Lidbury's death. We are unable to find that the joint and mutual will was a contract that acted to limit Mr. Lidbury's right of disposition of the property at the time of Mrs. Lidbury's death. Furthermore, Mr. Lidbury could have, under Illinois law, revoked the will before his death had it not been in obvious accord with his personal wishes.

Even were we to assume that this will was an irrevocable contract upon Mrs. Lidbury's death, it would not result in the transfer of a present interest in the property of the survivor. The effect is contractual, not dispositive. *Brown v. Commissioner*, 52 T.C. 50, 66 (1969). It is settled law that a will speaks only at the time of the testator's death. Mr. Lidbury, by using the joint and mutual will as his own, made a testamentary disposition, not an inter vivos transfer. *Brown v. Commissioner*, *supra* at 58. No transfer taxable as a gift occurred when Mrs. Lidbury died, and Mr. Lidbury's estate includes the value of the unsold property.

The second issue is whether transfers made by William A. Lidbury, deceased, are includable in his gross estate as gifts made in contemplation of death under section 2035, which provides, for transfers made before January 1, 1977:

SEC. 2035(a). GENERAL RULE.—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale

for an adequate and full consideration in money or money's worth), by trust or otherwise, in contemplation of his death.

(b) APPLICATION OF GENERAL RULE.—If the decedent within a period of 3 years ending with the date of his death * * * transferred an interest in property, * * * such transfer * * * shall, unless shown to the contrary, be deemed to have been made in contemplation of death within the meaning of this section * * * [8]

The issue of whether a gift was made in contemplation of death is a factual one requiring an examination of all of the evidence for a determination of whether the decedent's motives were associated with life or with death. *United States v. Wells*, 283 U.S. 102, 117 (1931). The phrase "in contemplation of death"—

does not have reference to that general expectation of death such as all persons entertain. On the other hand, its meaning is not restricted to an apprehension that death is imminent or near. A transfer "in contemplation of death" is a disposition of property prompted by the thought of death (although it need not be solely so prompted). A transfer is prompted by the thought of death if (1) made with the purpose of avoiding death taxes, (2) made as a substitute for a testamentary disposition of the property, or (3) made for any other motive associated with death. The bodily and mental condition of the decedent and all other attendant facts and circumstances are to be scrutinized in order to determine whether or not such thought prompted the disposition. [Sec. 20.2035–1(c), Estate Tax Regs.]

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[8] Sec. 2035 was amended, and a new sec. 2035(c) added, by the Tax Reform Act of 1976, Pub. L. 94–455, sec. 2001(a)(5), 90 Stat. 1520, 1843, effective for estates of decedents dying after Dec. 31, 1976, except that the provisions do not apply to transfers made before Jan. 1, 1977. These sections provide:

SEC. 2035(a). INCLUSION OF GIFTS MADE BY DECEDENT.—Except as provided in subsection (b), the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the 3-year period ending on the date of the decedent's death.

(b) EXCEPTIONS.—Subsection (a) shall not apply to—

* * * * * * *

(2) any gift excludable in computing taxable gifts by reason of section 2503(b) (relating to $3,000 annual exclusion for purposes of the gift tax) determined without regard to section 2513(a).

(c) INCLUSION OF GIFT TAX ON CERTAIN GIFTS MADE DURING 3 YEARS BEFORE DECEDENT'S DEATH.—The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse after December 31, 1976, and during the 3-year period ending on the date of the decedent's death.

Despite the fact that Mr. Lidbury died after Dec. 31, 1976, none of these subsections applies to the issues for decision in this case as the gifts made in January 1977 are not at issue in the present case, and these subsections are inapplicable to transfers made before Jan. 1, 1977.

Whether a transfer "was made in contemplation of death within the meaning of section 2035 depends upon the dominant motive of the decedent which we must determine on the basis of all of the facts and circumstances." *Estate of Lowe v. Commissioner*, 64 T.C. 663, 672 (1975) (fn. ref. omitted), affd. 555 F.2d 244 (9th Cir. 1977); *Allen v. Trust Co.*, 326 U.S. 630, 636 (1946).

Petitioner contends that the gifts were part of a regular pattern of giving, that the gifts were in appreciation for past years of labor performed without compensation, and that the gifts were for the pleasure of seeing the recipients enjoy them rather than in contemplation of death.

Respondent counters that there was no apparent pattern of giving, that the gifts were a substitution for testamentary disposition, and that Mr. Lidbury made these gifts in contemplation of death. The Commissioner's determination that gifts by Mr. Lidbury were transfers made in contemplation of death "is entitled to the usual presumptive correctness and, in addition, is entitled to the rebuttable statutory presumption that the transfers were made in contemplation of death." *Estate of Zaiger v. Commissioner*, 64 T.C. 927, 937 (1975); Rule 142(a).

In making a determination of the decedent's motives, the courts have looked to several factors:

> (a) The age of the decedent at the time the transfers were made; (b) the decedent's health, as he knew it, at or before the time of the transfers; (c) the interval between the transfers and the decedent's death; (d) the amount of the property transferred in proportion to the amount of property retained; (e) the nature and disposition of the decedent * * *; (f) the existence of a general testamentary scheme of which the transfers were a part; (g) the relationship of the donee or donees to the decedent, i.e., whether they were the natural objects of his bounty; (h) the existence of a long established gift-making policy on the part of the decedent; (i) the existence of a desire on the part of the decedent to escape the burden of managing property by transferring the property to others; (j) the existence of a desire on the part of the decedent to vicariously enjoy the enjoyment by the donees of the property transferred; and (k) the existence of the desire by the decedent of avoiding estate taxes by means of making *inter vivos* transfers of property. [*Estate of Johnson v. Commissioner*, 10 T.C. 680, 688 (1948).]

Mr. Lidbury was generally healthy for a man of his age, active in the operations of several family farms, and a participant in various family activities. The fact that he

underwent prostate surgery in 1974 and in 1976 gave him no reason to feel that death was any more likely than it would otherwise be for a man of his age. The prostate condition was specifically stated on his death certificate not to be a cause of death. His siblings were long lived, and Mr. Lidbury was not receiving treatment for the mature-onset diabetes that was the family's most usual cause of death. Further, his death was caused by neither diabetes nor the prostate problems, but rather by heart disease. Although Mr. Lidbury developed the various problems of old age, such as arthritis, petitioner has met his burden of proving that Mr. Lidbury had no more than the "general expectation of death such as all persons entertain." Sec. 20.2035–1(c), Estate Tax Regs.; Rule 142(a).

The chart of the gifts during the final 4 years of Mr. Lidbury's life, which includes 5 calendar years, indicates a clear pattern of giving, albeit on a random basis and in random amounts, which is demonstrative of a "pattern of benevolence not engendered by the thought of death." *Cunningham v. United States*, 553 F.2d 394, 397 (5th Cir. 1977); *Estate of Hill v. Commissioner*, 64 T.C. 867 (1975), affd. without published opinion 568 F.2d 1365 (5th Cir. 1978). Mr. Lidbury's family had assisted him over a period of decades with no recompense or financial reward, and he enjoyed giving them money as it became available to him. These are life-related, not death-related motives. *United States v. Wells*, *supra* at 118–119.

When transfers are made with the advice of a lawyer or tax counselor in connection with a complete estate plan without other life-related motivation, the transfers are made in contemplation of death. *Estate of Carnall v. Commissioner*, 25 T.C. 654 (1955). It is apparent, however, that Mr. Lidbury made the gifts of 1973 and 1974 without the knowledge of his attorney. Mr. Lidbury was, therefore, aware of the specific exemption and $3,000 annual exclusions without the benefit of legal advice. Further, although the gifts were made in roughly equal amounts to the families of each of his children, the equal distribution under the will was either unknown or not remembered at the time of the gifts. "It is entirely normal for an individual to make gifts during his lifetime to the natural objects of his affection and bounty." *Cunningham v. United States*, *supra* at 397. The equal distribution was not a substi-

tute for testamentary disposition, nor were the gifts made in order to avoid estate taxes. *Estate of McIntosh v. Commissioner*, 25 T.C. 794 (1956), affd. 248 F.2d 181 (2d Cir. 1957).

When these general findings are applied to the gifts of December 1974, it is clear that these gifts were made months after both the first surgery and Mr. Lidbury's successful recovery from the operation. These gifts were, therefore, not "in contemplation of death" and are not includable in Mr. Lidbury's estate under section 2035(a).

The gifts made in August 1975 were also not prompted by death-related motives but rather continued a pattern of gift-giving in appreciation of past services over decades of working the family farms together. Mr. Lidbury had a source of readily available funds for gifts from the sale of the 80-acre farm, a situation analogous to that in *Estate of Holding v. Commissioner*, 30 T.C. 988 (1958). Mr. Lidbury also had a number of other purposes for making the gifts of August 1975, including a desire to see his granddaughter complete college, and a general wish to see the recipients enjoy the gifts. Mr. Lidbury's age alone is insufficient to transform these gifts into transfers made in contemplation of death. *Cunningham v. United States*, *supra*; *Estate of Hill v. Commissioner*, *supra*. The August 1975 gifts are, therefore, not includable in Mr. Lidbury's estate.

The gifts of January 1976 were made shortly after Mr. Lidbury entered the nursing home, but also shortly after his full participation in a family Christmas celebration. Although he was not in perfect health, these gifts are a clear extension of his past gift-giving in appreciation for his family's past efforts, and for the pleasure of giving, and, therefore, are also not includable in his estate.

In order to reflect the foregoing,

Decisions will be entered for the petitioner.

JOHN F. KNOWLTON AND BETTY W. KNOWLTON, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 22639–81 (Non-Nitrol Issues). Filed February 6, 1985.

Petitioners received as part of a liquidating distribution from Dunmovin Corp. 24,950 shares of General Motors common stock, which Dunmovin had received after 1953 as a result of the court-ordered divestiture by E.I. duPont de Nemours & Co. of its interest in General Motors. Dunmovin acquired its interest in duPont prior to 1954. *Held*, the General Motors stock was, for purposes of sec. 333(e)(2), I.R.C. 1954, acquired by Dunmovin after Dec. 31, 1953.

Herbert L. Camp, for the petitioners.
Robert W. West and *Jillena A. Warner*, for the respondent.

OPINION

TANNENWALD, *Judge*: Respondent determined deficiencies in petitioners' Federal income tax for the taxable years ending December 31, 1977, and December 31, 1978, of $61,924 and $63,281, respectively. In his answer, respondent asserted an increased deficiency for 1978 of $10,451. These deficiencies concern the "Nitrol issues" arising from respondent's adjustments to petitioners' Schedules C, and were the subject of a trial held before Judge Nims on December 12, 1983. In his amended answer, respondent alleged an additional increased deficiency for 1978 of $585,034.66, all of which concerns the treatment of stock received in a corporate liquidation (the "non-Nitrol issue"). By orders of December 5, 1983, and March 20, 1984, the Court granted the parties' joint motion to sever the Nitrol and non-Nitrol issues for purposes of trial, briefing, and opinion. The non-Nitrol issue, the sole subject of this opinion, was submitted to the Court fully stipulated pursuant to Rule 122[1] on December 12, 1983. The only issue for our decision is whether certain stock distributed to petitioner

[1]Unless otherwise indicated, all Rule references are to the Rules of Practice and Procedure of this Court, and all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the taxable year in issue.

Betty W. Knowlton[2] during taxable year 1978 in liquidation of a corporation of which she was a shareholder was "acquired by the corporation after December 31, 1953" within the meaning of section 333(e)(2).

The stipulation of facts and attached exhibits are incorporated herein by this reference. At the time they filed their petition, petitioners resided in St. Petersburg, Florida. Petitioners filed a joint tax return for 1978.

Prior to June 1978, petitioner owned 975 shares of nonvoting common stock in the Dunmovin Corp. (Dunmovin), a personal holding company having its principal place of business in Dover, Delaware. Dunmovin was liquidated during June 1978 pursuant to section 333, and petitioner was a "qualified electing shareholder" of Dunmovin within the meaning of section 333(c). Petitioner received from Dunmovin a liquidating distribution of $75,723.59 in cash and $5,795,740.02 in marketable securities (at fair market value). Included in the distribution of marketable securities to petitioner were 24,950 shares of common stock in General Motors Corp. (the GM stock or shares).

Dunmovin had received the GM stock from E.I. duPont de Nemours & Co. (duPont) during the taxable years 1962, 1964, and 1965 as a result of the divestiture order by the U.S. Supreme Court in the antitrust decisions in *United States v. E.I. duPont de Nemours & Co.*, 353 U.S. 586 (1957), 366 U.S. 316 (1961). Dunmovin, a passive shareholder of duPont, had no role in the management of duPont, was not a party to the antitrust litigation resulting in duPont's distribution of the GM stock, and did not initiate, consent to, or approve the distribution. Dunmovin acquired the duPont stock with respect to which it received the antitrust distribution prior to 1954, and duPont acquired the GM stock prior to 1954. DuPont was itself eligible to be liquidated under section 333.

At the time duPont distributed the GM stock to Dunmovin, the distribution was taxed to Dunmovin as a dividend in the amount of the adjusted basis of the GM stock in the hands of duPont (see section 301(b)(1)(B)) and was eligible for the 85 percent dividends received deduction under section 243. Pursuant to section 301(d)(2), the adjusted basis of the GM stock in

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[2] As the shares involved in the non-Nitrol issue were owned by petitioner Betty W. Knowlton, we will hereinafter refer to Mrs. Knowlton as petitioner and Mr. and Mrs. Knowlton as petitioners.

the hands of Dunmovin was carried over from that of duPont. Consequently, Dunmovin's holding period for the GM stock included the period duPont had held such stock. Sec. 1223(2).

The only point of contention between the parties is the legal issue of whether the GM stock, distributed to Dunmovin in 1962, 1964, and 1965 with respect to its duPont stock acquired before 1954, was "acquired" by Dunmovin "after December 31, 1953" within the meaning of section 333(e)(2).[3] If it was, then petitioners realized long-term capital gain for 1978 by virtue of the distribution of the GM shares. If, however, the shares were "acquired" by Dunmovin before 1954, the GM shares were properly excluded from petitioners' gain computation under section 333(e)(2).[4] Respondent contends that with minor exceptions, not applicable herein, the date stock or securities are "acquired" within the meaning of section 333(e)(2) is the date they are received. Petitioners contend that the date of acquisition within the meaning of section 333(e)(2) should relate back where there is a substitution of basis and a tacking of holding period with respect to the stock or securities acquired[5] or where they have been acquired involuntarily.

The issue is a narrow one, i.e., the meaning of the word "acquired" in section 333(e)(2), and, aside from interpretative rulings by respondent hereinafter discussed (see *infra* pp. 165–168, the case is one of first impression. For the reasons hereinafter set forth, we hold for respondent.

The Supreme Court in *Commissioner v. Brown*, 380 U.S. 563 (1965), set forth the guidelines for our decision. The Court

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[3]Sec. 333(e) provides as follows for noncorporate shareholders receiving a liquidating distribution under sec. 333—

(1) there shall be recognized, and treated as a dividend, so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, such earnings and profits to be determined as of the close of the month in which the transfer in liquidation occurred under subsection (a)(2), but without diminution by reason of distributions made during such month; but by including in the computation thereof all amounts accrued up to the date on which the transfer of all the property under the liquidation is completed; and

(2) there shall be recognized, and treated as short-term or long-term capital gain, as the case may be, so much of the remainder of the gain as is not in excess of the amount by which the value of that portion of the assets received by him which consists of money, or of stock or securities acquired by the corporation after December 31, 1953, exceeds his ratable share of such earnings and profits.

[4]The parties have stipulated all the necessary elements to calculate petitioners' long-term capital gain, if the GM stock was "acquired [by Dunmovin] after December 31, 1953."

[5]There is no dispute between the parties that the basis and holding period of the GM stock acquired by Dunmovin is computed by reference to the basis and date of acquisition thereof by duPont.

pointed out, on the one hand, that the "common and ordinary meaning [of a word] should at least be persuasive of its meaning as used in the Internal Revenue Code," but, on the other hand, that the courts have some leeway in interpreting a statute if the adoption of a literal or usual meaning of its words "would lead to absurd results * * * or would thwart the obvious purpose of the statute." See 380 U.S. at 571 (quoting *Helvering v. Hammel*, 311 U.S. 504, 510–511 (1941)).

Turning to the first guideline, it seems to us that, in common parlance, one cannot be said to "acquire" property before one obtains ownership, possession, or control over it. Applying this standard, it seems clear that Dunmovin did not "acquire" the GM stock until after December 31, 1953. We are reluctant, however, to go so far as to equate what we believe to be the common and ordinary meaning of the word "acquired" in section 333(e)(2) unqualifiedly with the "plain meaning" of that word. There may be situations where, as respondent himself has ruled, the "acquired" shares represent no more than a substitution for, or additional shares of the same type as, shares previously acquired. See Rev. Rul. 56–171, 1956–1 C.B. 179, discussed at p. 165 *infra*. Given our reluctance, we think there is room to examine the legislative history and policy which underlie the statutory provisions involved in the instant case. See, e.g., *Abdalla v. Commissioner*, 647 F.2d 487, 496–499 (5th Cir. 1981), affg. 69 T.C. 697 (1978).

Section 333(e)(2) was originally enacted in 1938, as a temporary relief measure designed to facilitate the liquidation of personal holding companies. Insofar as the instant case is concerned, the language utilized was the same as is presently contained in section 333(e)(2), except that the operative date with respect to stock or securities "acquired" (the "cutoff date") was April 9, 1938. See J. Seidman, Legislative History of Federal Income Tax Laws 1938–1861, at 49–52 (1938). The provision was reenacted as a temporary measure in 1943, 1950, and 1951 and was the subject of unsuccessful attempts at reenactment in 1942 and 1948. For the details of the various committee reports and comments on the floor of Congress, see I J. Seidman, Legislative History of Federal Income and Excess Profits Tax Laws 1953–1939, at 1541–1550 (1954). When the Internal Revenue Code was enacted, the temporary relief provision was made permanent in section 333 with a

cutoff date of December 31, 1953. For the legislative history, see S. Rept. 1622, 83d Cong., 2d Sess. 48, 256 (1954); Conf. Rept. 2543, 83d Cong., 2d Sess. 41 (1954). Our examination of the legislative history unfortunately reveals, with one possible exception, nothing which would cast light on any purpose behind these recurring legislative actions other than to continue to facilitate personal holding company liquidations. The exception, upon which petitioners seize to support their position, is the following statement in the 1950 Senate Finance Committee Report: "To avoid conversion of the assets of the corporation into stock or securities which could be distributed tax-free in anticipation of legislative action restoring section 112(b)(7) [of the 1939 Internal Revenue Code], the basic [cutoff] date * * * is made August 15, 1950, the date when this legislation was approved by your committee." S. Rept. 2375, 81st Cong., 2d Sess. 63 (1950). We think this language does no more than to exhibit legislative concern with an obvious means of tax avoidance which, if not covered, could frustrate the requirement of section 333 that a stockholder's gain be recognized to the extent of cash received. See B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, par. 11.21, at 11–25 (4th ed. 1979). See also Rev. Rul. 76–392, 1976–2 C.B. 249; Burke, "Section 333 Liquidations—Boon or Bust?" 21 Baylor L. Rev. 185, 191 (1969). It cannot be transformed, as petitioners argue, into a legislative manifestation that transactions not involving such conversion were of no concern to the Congress and therefore should be exempted from the "acquired" condition of section 333(e)(2).

Similarly, we are not prepared to accept petitioners' argument that a 1969 amendment to section 333(e) indicates a legislative policy to exempt transactions of the type involved herein. Section 917 of the Tax Reform Act of 1969, Pub. L. 91–172, 83 Stat. 724 (1969), provided that stock or securities distributed by a corporation liquidating during 1970 would be treated as having been "acquired" by the corporation before January 1, 1954, if they were acquired from a limited class of persons solely for stock of the corporation in a section 351 transaction, and the holding period of such stock or securities included a period before January 1, 1954. What little legislative history there is reveals that the amendment was intended to cover one particular holding company in the State of

Washington (see 115 Cong. Rec. S16385 (daily ed., Dec. 10, 1969) (remarks of Senator Bennett)), and that the Congress assumed that a correct interpretation of the "acquired" condition of section 333(e)(2) necessitated remedial legislation to provide the desired limited exception.[6] See Staff of Joint Comm. on Taxation, 91st Cong., 1st Sess., General Explanation of the Tax Reform Act of 1969, at 253 (Comm. Print 1970); H. Rept. 91–782, at 337 (1969). Here again, we think petitioners distill too much from what is at best a meager reflection of legislative purpose.

Thus, the legislative history of section 333(e)(2) is not particularly helpful in pointing the way to decision in the instant case. One other tool is available to us, namely, the manner in which respondent, as the Commissioner of the agency responsible for the administration of the revenue laws, has interpreted the "acquired" condition of section 333(e)(2). While respondent's rulings are not binding upon us (*Dixon v. United States*, 381 U.S. 68, 74–75 (1965); *Stubbs, Overbeck & Associates v. United States*, 445 F.2d 1142, 1146–1147 (5th Cir. 1971); *Linseman v. Commissioner*, 82 T.C. 514, 520 (1984)), we are entitled to utilize such rulings as an aid to interpretation. *Hanover Bank v. Commissioner*, 369 U.S. 672, 686–687 (1962); *Union Carbide Corp. v. Commissioner*, 75 T.C. 220, 247–248 (1980), affd. per curiam 671 F.2d 67 (2d Cir. 1981). In his first interpretation of section 333(e)(2), Rev. Rul. 56–171, 1956–1 C.B. 179, respondent considered stock received by a corporate shareholder in a statutory merger qualifying under section 368(a)(1)(A). For purposes of the subsequent liquidation of the corporate shareholder, respondent ruled that the stock was "acquired," within the meaning of section 333(e)(2), as of the date the corporate shareholder acquired the stock in exchange for which it received the stock being distributed. Thus, respondent, without explanation, allowed the corporation to relate its post-1953 acquisition back to a date before 1954.

In Rev. Rul. 58–92, 1958–1 C.B. 174, respondent treated stock and securities received from an individual shareholder in a section 351 transaction differently. Noting that the

[6] Although the legislative history makes no reference to how respondent had applied sec. 333(e)(2) when there had been a prior sec. 351 exchange, the fact of the matter is that respondent had interpreted the "acquired" condition with what appears to have been the assumption underlying sec. 917 of the Tax Reform Act of 1969. Rev. Rul. 56–171, 1956–1 C.B. 179.

liquidating corporation had taken the stock and securities with a carryover basis and holding period from the contributing shareholder, respondent nevertheless treated the transfer as a purchase with contributed cash, and found that the stock was "acquired" on the date of receipt from the shareholder. Respondent stated a general rule that stock and securities will be treated as cash equivalents for purposes of section 333 (i.e., there will be no relation back of the "acquired" date) unless they were owned by an existing corporation on December 31, 1953, or "received, with respect to stock or securities owned on that date, in a nontaxable exchange pursuant to a plan of reorganization or as a nontaxable stock dividend." Respondent reasoned that reorganizations and stock dividends were not section 333(e)(2) "acquisitions," but were instead "merely changes in the nature or form of stock already owned by the liquidating corporation." As the stock and securities were transferred by an individual after December 31, 1953, to a newly formed corporation which was not in existence on that date, respondent refused to relate the acquisition back to the individual shareholder's acquisition date.[7]

In Rev. Rul. 64–257, 1964–2 C.B. 91, respondent ruled that the "acquired" date was the date of receipt in a situation in which a liquidating corporation had received the distributed stock from a *foreign* predecessor corporation in a nontaxable reorganization. Noting that the reorganization did not involve an exchange of stock held on December 31, 1953, for the new stock, respondent distinguished Rev. Rul. 56–171, *supra*, on the basis that stock or securities held by a corporation itself unable to qualify for section 333 treatment are not owned by an "existing corporation" for purposes of the rule set forth in Rev. Rul. 58-92, *supra*.[8]

We are unpersuaded by petitioners' contention that respondent's rulings support their position. They point to Rev. Rul 64–257, *supra*, and argue that since that ruling was grounded

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[7] See discussion, pp. 164–165 *supra*, of the limited exception governing a sec. 351 transaction, which Congress enacted in the Tax Reform Act of 1969.

[8] In Rev. Rul. 78–350, 1978–2 C.B. 135, respondent took the same position as he takes herein with respect to what appears to be the same transaction, i.e., the distribution by a personal holding company in sec. 333 liquidation of stock received by the liquidating corporation as a result of an antitrust divestiture decree. Since that revenue ruling reflects little more than a reliance on Rev. Rul. 58–92, 1958–1 C.B. 174, and cursorily distinguishes Rev. Rul. 56–171, *supra*, and since respondent disclaims any reliance thereon, we find it unnecessary to consider what weight, if any, we should accord to it. See *Ludwig v. Commissioner*, 68 T.C. 979, 985–986 n. 4 (1977).

on the fact that the distributed stock was acquired in a nontaxable exchange from a foreign corporation ineligible to qualify for the benefits of section 333, and duPont was an eligible domestic corporation, ergo the inference to be drawn from the revenue ruling is that the transaction herein qualifies. Petitioners' logic is flawed because it does not necessarily follow from the fact that (1) if condition A exists, consequence B results, that (2) if condition A does not exist, consequence B will not result. See I. Copi, Introduction to Logic 234 (4th ed. 1972). Moreover, we note that the GM stock was not acquired by Dunmovin in a nontaxable exchange but rather in a taxable transaction, where no exchange was involved. See *infra* p. 168. Dunmovin received the GM stock, and its previous holding in duPont was now changed into a holding of duPont *and* GM shares, a holding quite different from that which would have obtained if duPont had issued a dividend in its own stock, i.e., a true stock dividend.

We are also unpersuaded that petitioners can draw any sustenance from G.C.M. 36743, which was directed to a proposed ruling by respondent which became Rev. Rul. 76–392, 1976–2 C.B. 249, dealing with the meaning of the word "acquisition" in section 1236(a)(1). Petitioners contend that the language of G.C.M. 36743 imports a "voluntariness" test into section 333(e)(2).[9] But the fact of the matter is that Rev. Rul. 76–392, *supra*, did not adopt the language of G.C.M. 36743, but instead utilized the cash conversion concept to explain the "acquired" condition of section 333(e)(2).[10] Moreover, respondent has disallowed relation back of the "acquired" date even where no cash was apparently exchanged in the transaction in which the liquidating corporation received the distributed

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[9]The relevant language in G.C.M. 36743 is as follows—

"the objective of Code sec. 333(f)(1) [the corporate shareholders' counterpart to sec. 333(e)(2)] is to prohibit the voluntary conversion of cash into securities in anticipation of a liquidating distribution in an attempt to defer recognition of gain at the shareholder level. Where the investment is not initiated by the liquidating corporation for these reasons, the objectives of Code sec. 333 do not demand treating the receipt of the security as an acquisition. Thus, Rev. Rul. 56–171 concludes that the receipt of shares pursuant to a tax-free statutory merger does not constitute an acquisition * * * since the transaction is a mere change in the nature of the security held, neither voluntarily undertaken or initiated by the liquidating corporation nor designed to convert cash into distributable property."

[10]Rev. Rul. 76–392 states: "This 'after acquired' stock is treated the same as cash to prevent the liquidating corporation from converting cash into stock or securities in an attempt to defer recognition of gain at the shareholder level." Rev. Rul. 76–392, 1976–2 C.B. 249. No further explanation of Rev. Rul. 56–171, *supra*, appears therein.

shares. Rev. Rul. 64–257, *supra* (stock acquired from foreign predecessor corporation in section 368(a)(1) exchange).

Petitioners further contend that the distribution of GM stock from duPont to Dunmovin was a nontaxable transaction and thus fits within the ambit of Rev. Rul. 58–92, *supra*, which holds that the date on which stock received as the result of a statutory merger or by way of a stock dividend was "acquired" within the meaning of section 333(e)(2) is a date earlier than the date of actual receipt. While it is true that sections 243, 301(b)(1)(B) and (d)(2), and 1223(2) combine to give the transfer of the GM stock a partially nontaxable status, it is clear that whether the transaction is taxable and whether the transferee receives a carryover basis and holding period are not determinative. In both Rev. Rul. 58–92 and Rev. Rul. 64–257, *supra*, involving transactions at least as tax advantaged as Dunmovin's receipt of the GM stock, respondent, stating that the transaction's nontaxable quality and carryover holding period were immaterial, refused to relate back to the "acquired" date. Instead, respondent relied on the distinction between acquisitions and mere changes in the form of previously owned assets. Thus, petitioners' assertion that respondent's rulings stand for the proposition that all tax-advantaged transactions qualify for favorable treatment under section 333 is simply not true.

Finally, we turn to petitioners' ultimate position, namely, that the acquisition by Dunmovin of the GM stock was involuntary and that therefore petitioners should not be penalized as a result of the liquidation of Dunmovin. In support of this position, petitioners argue that section 1111 (Pub. L. 87–403, 76 Stat. 4 (1962), repealed by Pub. L. 94–455, sec. 1901(a)(134), 90 Stat. 1786 (1976)) reflects a legislative policy to aid individual shareholders affected by the involuntary acquisition of General Motors shares pursuant to the distribution resulting from the duPont divestiture, and that this policy should be a guideline for interpreting the "acquired" condition of section 333(e)(2). Petitioners' argument is flawed in several respects. First, there is not the slightest indication in the legislative history of section 1111 that Congress even considered the interrelationship between that section and section 333. Such silence stands in sharp contrast to the numerous other sections of the Code which Congress took into account in enacting section 1111. H. Rept. 1157, 87th

Cong., 1st Sess. (1961); S. Rept. 1100, 87th Cong., 1st Sess. (1961); H. Rept. 1128, 86th Cong., 1st Sess. (1959). See *Commissioner v. Korell*, 339 U.S. 619, 625–626 (1950), where the Supreme Court emphasized the absence of any indication that Congress had considered a significant loophole in the applicable statutory provision. Second, it is clear from section 1111 and the accompanying legislative history that Congress deliberately conferred a benefit upon corporate shareholders, such as Dunmovin, by according them the 85 percent dividends received deduction rather than the return-of-capital treatment it bestowed upon individual shareholders. Thus, it cannot be said that individual shareholders were the primary beneficiaries of legislative largess—a largess from which Dunmovin has already benefited. Third, section 1111 dealt with a problem which, at most, peripherally affected the operation of section 333. To support legislative intent from the action of a subsequent Congress not directly affecting the particular statutory provision in question would far exceed the permissible bounds of statutory construction. *Penn Mutual Co. v. Lederer*, 252 U.S. 523, 535, 537–538 (1920); *Estate of Stoll v. Commissioner*, 38 T.C. 223, 246–247 (1962). Fourth, we think it significant that, in the final analysis, the adverse tax consequence which petitioners seek to avoid herein stemmed from a *voluntary* act, namely, the liquidation of Dunmovin. That petitioners find themselves unable to take advantage of an ancillary tax benefit is irrelevant. Cf. *Central Tablet Manufacturing Co. v. United States*, 417 U.S. 673 (1974), where the happenstance of a fire precluded the taxpayers from satisfying the requirements of section 337. Moreover, even where involuntary action has produced an adverse consequence to a taxpayer, the Supreme Court has not deemed such an event sufficient to cause a modification of the word "sale" in the statutory provisions dealing with capital gains and losses. *Helvering v. Hammel*, 311 U.S. 504 (1941).

The long and the short of the matter is that applying the guidelines articulated in *Commissioner v. Brown* (see *supra* p. 162–163), we see no basis for concluding that the "common and ordinary meaning" should not be accorded the word "acquired" in section 333(e)(2), because to do so "would lead to

absurd results * * * or would thwart [its] obvious purpose." Accordingly,

An order will be entered holding for respondent on the severed non-Nitrol issue.

ESTATE OF HENRY C. BICKMEYER, VIOLA BICKMEYER AND FRANCIS B. FROEHLICH, EXECUTORS, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 16039–80. Filed February 6, 1985.

Henry C. Bickmeyer was a shareholder in two corporations. Prior to his death on Nov. 15, 1973, Nassau County, New York, had taken all of the assets of the corporations by eminent domain; the corporations had voted to dissolve and liquidate under sec. 337, I.R.C. 1954; Nassau County had paid part of the value of the condemned assets to the corporations; and the corporations had distributed part of the condemnation proceeds to the shareholders. The corporations (or their trustees in dissolution) were litigating claims to additional amounts of compensation for their assets. After decedent's death, his estate received additional liquidation proceeds from the corporations in fiscal year 1974 and from the trustees in dissolution in fiscal year 1976. *Held*, the gains from the liquidation of the corporations received by decedent's estate in fiscal years 1974 and 1976 were income in respect of a decedent under sec. 691(a)(1), I.R.C. 1954, and the estate is not entitled to a step up in basis for the stock rights in the two corporations under sec. 1014(a) and (c), I.R.C. 1954.

William E. deBruin, Jr., for the petitioner.
Peter Devlin, for the respondent.

OPINION

FEATHERSTON, *Judge*: Respondent determined deficiencies in the amounts of $58,276 and $43,300 in petitioner's Federal income tax for the fiscal years ended October 31, 1974, and October 31, 1976, respectively. Other issues having been settled by the parties, the only issue remaining for decision is whether liquidating distributions received by petitioner, the Estate of Henry C. Bickmeyer, deceased, from Hempstead Bus

Corp. and H.B. Land Corp. in the fiscal years ended October 31, 1974, and October 31, 1976, constituted income in respect of a decedent within the meaning of section 691(a)(1).[1]

All the facts are stipulated.

Henry C. Bickmeyer (sometimes hereinafter decedent) died on November 15, 1973. Viola Bickmeyer and Francis B. Froehlich were appointed and qualified as coexecutors of his will by order of the Surrogate's Court of Nassau County, New York. When the petition was filed, the legal residence of Viola Bickmeyer was Fort Lauderdale, Florida, and that of Francis B. Froehlich was Brookville, New York. Decedent's estate (petitioner) filed its fiduciary income tax returns using a fiscal year ending October 31.

At the time of his death, decedent owned 489 of the 490 outstanding shares of Hempstead Bus Corp. (Bus) and 2,500 of the 10,000 outstanding shares of H.B. Land Corp. (Land). On the date of his death, decedent had a basis for his stock in Bus of $71,847 and a basis of $0 for his stock in Land.

1. Condemnation of Assets of Bus and Land

For a period prior to June 3, 1973, Bus operated bus lines in Nassau County, and Land owned a bus garage and maintenance facility which it had leased to Bus. On March 30, 1973, Nassau County initiated a condemnation proceeding in the local Supreme Court for the acquisition of all of the assets of Bus and Land. In its petition in the condemnation proceeding, the county alleged that the assets of Bus and Land had fair market values of $588,340 and $584,350, respectively, and, as consideration for the acquisition of their assets, the county offered to pay the corporations those amounts. Land and Bus answered the petition, denying the accuracy of the alleged values and claiming just compensation for their assets based on appraisals showing values of $1,074,933 and $1,308,000, respectively, for the assets of Bus and Land.

On June 1, 1973, the court granted the county's application to condemn the properties and placed the issue as to the fair market values thereof on a special calendar of the court. Nassau County acquired and took possession of all of the assets

[1] All section references are to the Internal Revenue Code of 1954 as amended, unless otherwise noted.

of Bus and Land on June 2, 1973. In accordance with New York law, Nassau County, in July 1973, paid Bus $588,340 and Land $584,350 as the appraised value of their assets.

Litigation ensued as to whether the remaining dispute concerning the fair market value of the properties should be resolved under the Nassau County Administrative Code or the New York Condemnation Law. The matter was finally resolved by a decision of the Appellate Division, Second Department, on May 6, 1974, that the case should be tried under the Nassau County Administrative Code without application of the New York Condemnation Law.

Thereafter, on March 23, 1976, the case was settled by agreement; total asset values, agreed upon, including the amounts paid in July 1973, were $958,780 for Land and $713,340 for Bus. On July 14, 1976, the balances of the condemnation awards were paid to the trustees in dissolution, $374,430 for Land and $125,000 for Bus. The trustees paid petitioner its proportionate shares.

2. Liquidation and Dissolution of Bus and Land

On May 30, 1973, Bus and Land formally voted to dissolve and liquidate under section 337. Of the condemnation proceeds paid to Bus in July 1973, the sum of $15,503 was distributed to decedent in July 1973 as a partial liquidating distribution. Of the condemnation proceeds paid to Land in July 1973, $75,000 was distributed to decedent as owner of 2,500 shares, and $60,000 was distributed to his wife, Viola Bickmeyer, as owner of 2,000 shares in the corporation. On the joint Federal income tax return filed on behalf of decedent and Viola Bickmeyer for 1973, these distributions were reported as long-term capital gains, computed by using the bases referred to above, and are not here in dispute.

Of the condemnation proceeds paid to Bus and Land in July 1973, Bus distributed $286,935 and Land distributed $33,996 to decedent's estate during the estate's fiscal year ended October 31, 1974.

Bus and Land on May 24, 1974, and May 29, 1974, respectively, distributed all of their remaining assets to the trustees in dissolution of the respective corporations. Among the assets distributed were the claims against Nassau County for additional condemnation awards. On the same respective dates,

certificates of dissolution were filed with New York State for the two corporations.

3. Tax Treatment of Receipts From Bus and Land

On their 1973 tax returns, Bus and Land reported their gains from the condemnation of their assets as nontaxable pursuant to section 337.

In the estate tax return (Form 706) for decedent's estate, the estate valued decedent's interest in Bus at $256,700 and in Land at $38,950. Upon audit, the estate tax examiner increased the value of decedent's interest in Bus to $385,096 and in Land of $135,101 based on the condemnation awards, including accrued interest. The estate concurred in the increase for estate tax purposes.

On its fiduciary income tax return for the fiscal year ended October 31, 1974, decedent's estate did not report any capital gain or loss in respect of the distributions received from Land and Bus. On its fiduciary income tax return for the fiscal year ended October 31, 1976, the estate reported a long-term capital gain of $27,836 with respect to Bus and a long-term capital loss of $26,979 with respect to Land.

In so reporting the transactions, petitioner claimed, and here contends, that its bases for the Bus and Land stocks were increased under section 1014(a) to amounts equal to the values of the stocks at the date of decedent's death (i.e., the agreed values per the estate tax audit). Accordingly, the estate treated the liquidating distributions from the two corporations in 1974 and most of the liquidating distributions in 1976 as returns of capital.

In the notice of deficiency, respondent determined that decedent's estate realized capital gains income of $124,542 in fiscal year ended October 31, 1974, and $96,049 in fiscal year ended October 31, 1976, as a result of the liquidating distributions from Bus and Land. In making this determination, respondent asserted that the liquidating distributions constituted income in respect of a decedent under section 691 and that section 1014 did not, therefore, provide a step up in petitioner's basis for the Bus and Land stock interests held by decedent at his death.[2]

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[2]Ancillary to respondent's determination under sec. 691 is the further determination that the estate is subject to a minimum tax under sec. 56 in respect of the tax preference items arising from

4. *Tax Consequences of the Distributions*

Section 1014(a)[3] provides generally, with certain stated exceptions, that the basis of property in the hands of a person acquiring the property from a decedent will be its fair market value at the date of decedent's death. Petitioner relies upon this general provision to support its contention that its bases for decedent's Bus and Land stock rights were stepped up to the amounts of their respective fair market values at decedent's death, as agreed by the parties for estate tax purposes. Section 1014(c), one of the exceptions to section 1014(a), provides, however, that section 1014 shall not apply to "property which constitutes a right to receive an item of income in respect of a decedent under section 691." The controlling issue here is thus whether petitioner's gains from the liquidation of Bus and Land were income in respect of a decedent.

Section 691(a)(1)(A) provides, in pertinent part, as follows:

> SEC. 691(a). INCLUSION IN GROSS INCOME.—
>
> (1) GENERAL RULE.—The amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death or a prior period (including the amount of all items of gross income in respect of a prior decedent, if the right to receive such amount was acquired by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent) shall be included in the gross income, for the taxable year when received, of:
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> (A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;

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the capital gains adjustment for the Bus and Land stock. The parties have stipulated that the determination of this Court with respect to the sec. 691 issue will dispose of this ancillary adjustment, and it will not be further discussed.

[3] SEC. 1014. BASIS OF PROPERTY ACQUIRED FROM A DECEDENT.

(a) IN GENERAL.—Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death, or, in the case of an election under either section 2032 or section 811(j) of the Internal Revenue Code of 1939 where the decedent died after October 21, 1942, its value at the applicable valuation date prescribed by those sections.

. . . . . .

(c) PROPERTY REPRESENTING INCOME IN RESPECT OF A DECEDENT.—This section shall not apply to property which constitutes a right to receive an item of income in respect of a decedent under section 691.

This statutory language is amplified by section 1.691(a)–1(b), Income Tax Regs., which is as follows:

(b) *General definition.* In general, the term "income in respect of a decedent" refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death * * *

The crucial language for our purposes is "the right to receive" gross income, as used in section 691(a)(1)(A), and "those amounts to which a decedent was entitled," as used in the regulation. Under this language, the courts have found a congressional intent to tax all items which can be considered gross income and to insure that the tax upon income that would have been derived had the decedent lived should not be lost as a consequence of his death. *Commissioner v. Linde*, 213 F.2d 1, 4, 5–6 (9th Cir. 1954), remanding 17 T.C. 584 (1951); *Estate of Sidles v. Commissioner*, 65 T.C. 873, 879–880 (1976), affd. without published opinion 553 F.2d 102 (8th Cir. 1977). For gains to be considered "income in respect of a decedent," however, section 691 requires that the decedent possess a right to that income as of the date of his death. *Trust Co. of Georgia v. Ross*, 392 F.2d 694, 695–696 (5th Cir. 1967); *Claiborne v. United States*, 648 F.2d 448, 452 (6th Cir. 1981). As stated in *Estate of Sidles v. Commissioner*, 65 T.C. at 880, in the case of a corporate liquidation:

Our point of inquiry must be whether the transaction had sufficiently matured as of decedent's death so as to create in him a right to receive the income when it was subsequently realized.

See also *Claiborne v. United States, supra* at 452; *Rollert Residuary Trust v. Commissioner*, 752 F.2d 1128 (6th Cir. 1985), affg. 80 T.C. 619 (1983). Whether a decedent possesses such a right is a question of fact, and each case depends upon its "subsisting facts." *Trust Co. of Georgia v. Ross*, 392 F.2d at 695.[4]

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[4]The legislative history of sec. 691 was succinctly stated in *Keck v. Commissioner*, 415 F.2d 531, 533 (6th Cir. 1969), revg. 49 T.C. 313 (1968), as follows:

"Under the prior law, only the items which were accruable to a taxpayer at the time of his death were required to be included in the last return. This discriminated against accrual-basis taxpayers and allowed much income of cash-basis taxpayers to escape income tax. To correct this situation, Congress provided that in the case of both cash and accrual taxpayers, the last return must include all items accruable at death. The Supreme Court, in Helvering v. Enright, 312 U.S. 636, 61 S.Ct.

We think it is clear that the liquidation of Bus and Land had progressed as of November 15, 1973, the date of decedent's death, to the point where decedent was entitled to, and had a right to receive, the liquidation proceeds. As detailed above, in March 1973, Nassau County initiated a condemnation proceeding in the local Supreme Court for the acquisition of all the assets of Bus and Land. In June 1973, Nassau County had taken title by eminent domain to all of the assets of Bus and Land, and had taken possession of all of their assets; the Nassau County Supreme Court had placed the corporations' claims for additional compensation for the assets on a special calendar for disposition. In July 1973, the county had paid the corporations the amounts of the county's appraisals. As early as May 30, 1973, the directors and shareholders of both Bus and Land had adopted resolutions to dissolve, to liquidate the corporations' assets, and to distribute the proceeds within 1 year. Both Bus and Land had made partial liquidating distributions to their shareholders, including decedent, consisting of a substantial amount of the cash proceeds of the condemnation. All of these steps were taken prior to decedent's death.

As a shareholder of the two corporations, decedent was required to do nothing further in order to receive his full share of the corporate proceeds. As of the date of his death, all that remained to be done under the respective plans of complete liquidation was to distribute the remainder of the corporate assets and to execute and file the certificates of dissolution with the State. Although the corporations were involved in litigation with Nassau County concerning the proper amounts of the condemnation awards at the time of decedent's death, decedent was not required as a shareholder to participate in that litigation in order to be entitled to his full share of the

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777, 85 L.Ed. 1093 held that the term "accrual" in the statute was not to be construed narrowly in its accounting sense, but broadly to effectuate the purpose of the statute. However, such broad construction resulted in the bunching of income in the last return and its resultant taxation in higher surtax brackets.

"It was to remedy this situation that Congress enacted the forerunner of Section 691, • • • which provides that such income as was formerly required to be included in the last return, because it was accrued [in the broad sense] though not actually received, is taxable to the recipient and has the same character in his hands that it would have had in the hands of the decedent."

See also *O'Daniel's Estate v. Commissioner*, 173 F.2d 966, 967-968 (2d Cir. 1949), affg. 10 T.C. 631 (1948); *Estate of Sidles v. Commissioner*, 65 T.C. 873, 878-879 (1976), affd. without published opinion 533 F.2d 102 (8th Cir. 1977); H. Rept. 2333, 77th Cong., 2d Sess. 84 (1942), 1942-2 C.B. 372; S. Rept. 1631, 77th Cong., 2d Sess. 101 (1942), 1942-2 C.B. 504.

proceeds, whatever the amount turned out to be.[5] He already had that right. Under the terms of the liquidation plans adopted by the corporations, the claims against Nassau County could be distributed to the trustees in dissolution along with all other assets, and this was in fact done in late May 1974. Only ministerial acts remained to be accomplished. Thus, at his death in November 1973, decedent had a "right to receive" the liquidation proceeds within the meaning of section 691(a)(1)(A). The liquidation gains when received were, therefore, income in respect of a decedent.

The case is analogous to *Estate of Sidles v. Commissioner*, 65 T.C. 873 (1976), affd. without opinion 553 F.2d 102 (8th Cir. 1977). In that case, Sidles was the sole shareholder of a corporation. Prior to his death, the corporation adopted a plan of complete liquidation and sold its principal asset. As of the date of Sidles' death, all that remained to be done was to adopt a corporate resolution to distribute, to distribute the assets, subject to liabilities, and to file the articles of dissolution with the State. This Court, holding that Sidles had a right to receive the liquidation proceeds at his death, and thus the liquidating gains received by the estate constituted income in respect of a decedent, stated (65 T.C. at 881):

> The liquidating distribution had its source exclusively in decedent's actions. His affirmative vote for liquidation created a right to receive that distribution, which right existed at his death. Although decedent had the power to rescind the transaction creating such a right, he had not attempted to do so before his death. Had the decedent lived to receive the liquidating distribution, it would have constituted income to him, and consequently such amounts constitute income in respect of a decedent when received by the estate.
>
> There can be no doubt that the estate acquired the right to receive the liquidation distribution from the decedent. The estate's right to such proceeds derived solely from decedent's death and not from its own efforts. Whatever actions the estate took were of no material significance here.
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> Furthermore, the actions of Bi-State's board of directors which remained to be done at the time of decedent's death do not derogate decedent's right to receive the liquidating distribution. The resolution of November 29, 1968, to distribute the assets in liquidation to decedent's estate, the declaration of the

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[5] Sec. 691 does not require that the amount to which the decedent is entitled be ascertainable at his death. *O'Daniel's Estate v. Commissioner*, 173 F.2d 966, 968 (2d Cir. 1949), affg. 10 T.C. 631 (1948); *Commissioner v. Linde*, 213 F.2d 1, 7 (9th Cir. 1954), remanding 17 T.C. 584 (1951); *Estate of Sidles v. Commissioner*, 65 T.C. 873, 894 (1976), affd. without published opinion 553 F.2d 102 (8th Cir. 1977).

liquidating dividend and the filing of articles of dissolution were mere formalities; ministerial acts necessary to complete the liquidation under State law. On the date of his death the decedent had performed enough substantive acts within his control to perfect his right to receive the liquidating distribution for purposes of section 691. Cf. *Hudspeth v. United States*, 471 F.2d 275 (8th Cir. 1972); *Kinsey v. Commissioner*, 477 F.2d 1058 (2d Cir. 1973), affg. 58 T.C. 259 (1972). [Fn. ref. omitted.]

This case is clearly distinguishable from *Keck v. Commissioner*, 415 F.2d 531 (6th Cir. 1969), revg. 49 T.C. 313 (1968), relied on by petitioners. In that case, Arthur D. Shaw (Shaw) owned stock in three companies which agreed, subject to Interstate Commerce Commission (ICC) approval, on March 1, 1956, to sell their assets. Shaw died on November 27, 1958. ICC approved the sale on May 5, 1960. The corporations were then liquidated and dissolved, and the proceeds were distributed to Shaw's estate. The Court of Appeals rejected the Commissioner's contention that the gains included in the proceeds were income in respect of a decedent on the ground that a number of contingencies operated to prevent Shaw's stock rights from maturing into a right to receive the sale proceeds: (1) The sale was subject to ICC approval; (2) as of the time of decedent's death, neither decedent nor the other stockholders were contractually committed to the plan to liquidate the corporations; (3) the majority stockholder (not Shaw) might have decided not to liquidate the corporation; and (4) decedent's own stock was not committed to vote for the liquidation plan until after his death. Because of these contingencies, the court found that the transaction had not sufficiently matured, as of the date of Shaw's death, to create in Shaw a right to receive the income when it was subsequently realized.

In the instant case, no comparable contingencies existed at decedent's death. As we have discussed, Nassau County had already taken by eminent domain all of the assets of Bus and Land. At decedent's death, the shareholders of Bus and Land had committed themselves to liquidate the corporations, and the corporations had already distributed some of the cash received for the assets. *Keck* is, therefore, inapposite.

Theoretically, petitioner as sole shareholder (except for one share) of Bus could have reversed the decision to liquidate Bus prior to his death, but it is stipulated that "No action was ever taken by any of the shareholders of either Bus or Land to revoke the liquidation and/or dissolution of the said corpora-

tions." Moreover, Bus's assets had been taken by Nassau County and part of its liquidation proceeds had been distributed prior to his death. While abandonment of Bus's impending dissolution may have been technically or theoretically possible, "the realities and substance of the events must govern our determination, rather than formalities and remote hypothetical possibilities." *Hudspeth v. United States*, 471 F.2d 275, 277 8th Cir. 1972); *Estate of Sidles v. Commissioner*, 65 T.C. at 880 n. 4.

To reflect the foregoing,

Decision will be entered for the respondent.

ALBERT G. WARFIELD III AND MARSHA WARFIELD, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 33146-83. Filed February 7, 1985.

Capital gains from sale of farmland development rights to the Maryland Agricultural Land Preservation Foundation are not exempted from the alternative minimum tax imposed by sec. 55, I.R.C. 1954, notwithstanding the Farmland Protection Policy set forth in 7 U.S.C. sec. 4201.

Albert G. Warfield III, pro se.
Robert A. Miller, for the respondent.

OPINION

COHEN, *Judge*: Respondent determined a deficiency of $10,151 in petitioners' Federal income taxes for 1981. Respondent also determined an addition to tax for negligence under section 6653(a)[1] in the amount of $507.55, but he has now conceded that addition to tax.

The issue to be determined is whether the Farmland Protection Policy set forth in 7 U.S.C. sec. 4201 precludes application of the alternative minimum tax of section 55 to

[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the year in issue.

capital gains derived from transfer of farmland development rights to the Maryland Agricultural Land Preservation Foundation.

All of the material facts have been stipulated, and the stipulation is incorporated herein by reference. Petitioners were residents of the State of Maryland at the time they filed their petition herein. They timely filed a joint individual income tax return for 1981 with the Internal Revenue Service Center at Philadelphia, Pennsylvania.

In 1955, petitioner Albert G. Warfield III (petitioner), inherited 229.88 acres of farmland in the State of Maryland. His basis in that land was $56,320.60. In 1980, he granted an easement of the development rights on that land to the Maryland Agricultural Land Preservation Foundation. The State of Maryland paid petitioner $75,000 in 1980 and $223,850 in 1981 for the easement.

On their joint return filed for 1981, petitioners reported long-term capital gain from the transfer of the development rights equal to the full amount received in that year. They paid $33,937 in "regular tax" at the time the return was ...ed. They did not pay any amount attributable to the alternative minimum tax imposed under section 55. They attached to the return a statement in which they asserted that the alternative minimum tax was not applicable to the gain realized from the transaction.

Petitioners contend that by adopting 7 U.S.C. sec. 4201, entitled "Farmland Protection Policy," Congress accorded special status to the relinquishment of development rights under an approved Federal or State farmland protection policy and that imposition of the tax under section 55 is inconsistent with and precluded by the following provision of 7 U.S.C. sec. 4203:

> (b) Each department, agency, independent commission, or other unit of the Federal Government, with the assistance of the Department of Agriculture, shall, as appropriate, develop proposals for action to bring its programs, authorities, and administrative activities into conformity with the purpose and policy of this chapter.

Petitioners do not and cannot cite any express provision compelling the result for which they argue. Moreover, we are unpersuaded by their arguments as a matter of statutory

construction. The unambiguous express provisions of section 55 are controlling in this case.

Section 55, which imposed the so-called "alternative minimum tax" was added to the Code by section 421 of the Revenue Act of 1978, Pub. L. 95–600, 92 Stat. 2763, 2871. During the year in issue, its pertinent provisions were as follows:

SEC. 55. ALTERNATIVE MINIMUM TAX FOR TAXPAYERS OTHER THAN CORPORATIONS.

(a) ALTERNATIVE MINIMUM TAX IMPOSED.—In the case of a taxpayer other than a corporation, if—

(1) an amount equal to the sum of—

(A) 10 percent of so much of the alternative minimum taxable income as exceeds $20,000 but does not exceed $60,000 plus

(B) 20 percent of so much of the alternative minimum taxable income as exceeds $60,000 but does not exceed $100,000, plus

(C) 25 percent of so much of the alternative minimum taxable income as exceeds $100,000, exceeds

(2) the regular tax for the taxable year,

then there is imposed (in addition to all other taxes imposed by this title) a tax equal to the amount of such excess.

(b) DEFINITIONS.—For purposes of this section—

(1) ALTERNATIVE MINIMUM TAXABLE INCOME.—The term "alternative minimum taxable income" means gross income—

(A) reduced by the sum of the deductions allowed for the taxable year,

(B) reduced by the sum of any amounts included in income under section 86 or 667, and

(C) increased by an amount equal to the sum of the tax preference items for—

(i) adjusted itemized deductions (within the meaning of section 57(a)(1)), and

(ii) capital gains (within the meaning of section 57(a)(9)).

For purposes of subparagraph (A) (and in determining the sum of itemized deductions for purposes of subparagraph (c)(i)), a deduction shall not be taken into account to the extent such deduction may be carried to another taxable year.

(2) REGULAR TAX.—The term "regular tax" means the taxes imposed by this chapter for the taxable year (computed without regard to this section and without regard to the taxes imposed by sections 72(m)(5)(B), 402(e), 408(f), 409(c), and 667(b)) reduced by the sum of the credits allowable under subpart A of part IV of this subchapter (other than under sections 31, 39 and 43). For purposes of this paragraph, the amount of the credits allowable under such subpart shall be determined without regard to this section.

"Tax preference items" as used in section 55(b)(1)(C) and section 57(a)(9) specifically include as part of the alternative

minimum tax base income the 60-percent deduction for net capital gains under section 1202.

These provisions and their history were most recently analyzed in *Huntsberry v. Commissioner*, 83 T.C. 742 (1984). In that case, we said that, although we are no longer foreclosed from inquiring into legislative purposes where a statute is clear on its face,

> we would require unequivocal evidence of legislative purpose before construing the statute so as to override the plain meaning of the words used therein. And this is particularly so in a case like the present, where we have a complex set of statutory provisions marked by a high degree of specificity. * * * [83 T.C. at 747–748.]

The legislative history of section 55 reveals no congressional intention or purpose whatsoever to exempt any form of capital gain, other than gain from the sale of a principal residence (section 57(a)(9)(D)), from the alternative minimum tax. See H. Rept. 95–1800 (Conf.) (1978), 1978–3 C.B. (Vol. 1) 521, 598–602.

We would certainly require specific evidence of legislative intent before we would conclude that a subsequently enacted nontax statute overrode specific provisions of a taxing statute. See *Bulova Watch Co. v. United States*, 365 U.S. 753, 757–758 (1961); *State Mutual Life Assur. Co. v. Commissioner*, 246 F.2d 319, 323–324 (1st Cir. 1957), affg. 27 T.C. 543 (1956). We find no such evidence, as neither the Farmland Protection Policy Act, 7 U.S.C. secs. 4201–4209, nor its legislative history, addresses the tax treatment of gain from the sale of farmland development rights. See Agricultural and Food Act of 1981, Pub. L. 97–98, secs. 1539–1549, 95 Stat. 1213, 1341–1344; H. Rept. 97–377 (Conf.) (1981), 1981 U.S. Code Cong. & Admin. News 2250, 2361–2362; S. Rept. 97–126 (1981), 1981 U.S. Code Cong. & Admin. News 1965, 2178–2180. Title 7, section 4203(b), relied on by petitioners and quoted above, obviously does not and could not require the Internal Revenue Service to adopt, administratively, regulations that would counteract express congressional enactments contained in the Internal Revenue Code. (By its terms, it only directs the development of *proposals*.)

Furthermore, retroactive effect will not be given a statute unless legislative intent to achieve that result is clear. See, e.g., *United States v. Magnolia Petroleum Co.*, 276 U.S. 160,

162 (1928). Congress' intention with respect to the Farmland Protection Policy Act is expressly to the contrary, however. The act provides that it does not become effective until 6 months from the date of enactment (December 22, 1981), or June 22, 1982, subsequent to the year in issue here. Pub. L. 97–98, sec. 1549, 95 Stat. 1213, 1344.

Petitioners present several other arguments that are equally unpersuasive. They claim that the alternative minimum tax provisions were not intended to apply to them because they paid a "substantial" regular tax. Their argument on this point, however, is based on legislative history and case law dealing with the "add on" minimum tax (formerly found in section 56), viz, *Wardas v. Commissioner*, T.C. Memo. 1983–137, and *Dupont v. United States*, 483 F. Supp. 588 (D. Del. 1980). As we said in *Huntsberry v. Commissioner*, *supra*:

> Although the term "alternative minimum tax" is confusingly similar to the term "minimum tax" already on the books for some 9 years, it nevertheless relates to a separate and distinct tax. Indeed, during 1979 and for several years thereafter a noncorporate taxpayer was subject to *both* the minimum tax and the alternative minimum tax. It is important that the difference between these two taxes be kept clearly in mind. To some extent, they have similar, but nevertheless at least partly different, objectives, and they are differently structured and have independent spheres of operation. [83 T.C. at 748–749; fn. ref. omitted.]

Section 55(a) is expressly structured so that the alternative tax is paid only if and to the extent that the alternative tax computation exceeds the taxpayer's regular liability. This provision was designed to overcome problems of equity and disincentive to capital formation perceived with reference to the "add on" minimum tax and reflected in the arguments relied on by petitioners. See, e.g., S. Rept. 95–1263 (1978), 1978–3 C.B. (Vol. 1) 315, 499–500. Congress has obviously taken the steps that it perceived to be necessary to correct the situation, and courts "are not authorized to rewrite a statute because they might deem its effects susceptible of improvement." *Badaracco v. Commissioner*, 461 U.S. 925 (1983); see also *David Metzger Trust v. Commissioner*, 76 T.C. 42, 80 (1981), affd. 693 F.2d 459 (5th Cir. 1982); *Estate of Cowser v. Commissioner*, 80 T.C. 783, 788 (1983), affd. 736 F.2d 1168 (7th Cir. 1984).

Petitioners next argue that the fact that the transaction was a "one time deal" with the State of Maryland for the benefit of the general public should militate against categorization of their gain as a tax preference. There is no justification for creating such an exception to the express terms of the statute. See *Frederick Smith Enter. Co. v. Commissioner*, 167 F.2d 356, 359 (6th Cir. 1948); *Sullivan v. Commissioner*, 76 T.C. 1156, 1158 (1981), affd. by unpublished order (10th Cir. 1983).

Similarly without merit is an assertion made by petitioners that their transaction was not really a "sale" and that they did not have a "true" capital gain. Petitioners reported the transaction correctly, as a capital gain under section 1201, and claimed a deduction under section 1202. There is no tenable argument that the incorporation of section 1202 into sections 55 and 57 does not apply to this transaction. See also *Parker v. Commissioner*, 74 T.C. 29, 33 (1980); *Sullivan v. Commissioner*, 76 T.C. at 1159. If the transaction were not a "true" capital gain, there would be no justification for reducing the taxable amount by 60 percent of the net income received.

We have considered petitioners' other arguments and found them to be without support in law or logic. Petitioners assert repeatedly the inequity of subjecting them to the alternative minimum tax under section 55 and argue that the tax is contrary to congressional policy with respect to farmland. Presumably, however, the farmland policy should encourage farmland preservation regardless of the tax situation of the particular owner of farmlands. If Congress had wanted to add additional incentives to farmland protection in the nature of tax benefits, some specific exclusion, deduction, method of calculation, or credit could have been provided. There is no reason to assume that a tax incentive would take the form of exemption from the alternative minimum tax, the impact of which is designed to and does substantially vary depending on the structure of the taxpayers' other income, deductions, and credits. We will not assume that Congress did indirectly what it could have, but has not, done directly.

Petitioners also argue that they might have planned the transaction differently (as an installment sale) if they had known that they would be subject to the alternative minimum tax computation. Petitioners did use income averaging in computing the tax due with their return. They have thus had

READEX FICHE

the benefit of a statutory provision expressly intended to cover some of the concerns that they have expressed in this case. If they had entered into an installment sales transaction, they might not have had the benefit of income averaging. We have no basis for determining which method would have resulted in less tax in the long run, and it is not material to our decision. In any event, petitioners are bound by the tax consequences of the transaction as it actually occurred.

Because of respondent's concession with respect to the additions to tax,

Decision will be entered for the respondent in the amount of the deficiency only.

HENRY N. AND MARILYN HULTER, ET AL.,[1] PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 3969–81, 23116–81, 36790–84, 40130–84. Filed February 11, 1985.

Petitioners filed a motion for summary judgment on the grounds that a bankruptcy court, with jurisdiction over the assets and liabilities of the debtor, determined in the bankruptcy proceeding the Federal income tax liabilities of the debtor's limited partners. *Held*, although in limited circumstances a bankruptcy court may have jurisdiction to determine certain Federal tax liabilities of individuals and entities other than the debtor in bankruptcy, the facts and circumstances of the bankruptcy proceeding in question herein would not have justified an adjudication in that proceeding of the Federal income tax liabilities of the limited partners, and the Bankruptcy Court did not do so.

Shlomo A. Beilis and *James J. Mahon*, for the petitioners.
Robert J. Foley, for the respondent.

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[1]Cases of the following petitioners are consolidated herewith: Henry N. and Marilyn Hulter, docket No. 23116–81; Henry N. Hulter and Marilyn N. Hulter, docket No. 36790–84; David Bryan and Islerose Bryan, docket No. 40130–84.

OPINION

SWIFT, *Judge*: This matter is before the Court on petitioners' motion for summary judgment filed on November 13, 1984. A hearing on the motion was held on December 20, 1984, in Boston, Massachusetts. These consolidated cases concern Tudor Associates, Ltd. II, a partnership which was engaged in real estate investments in North Carolina (hereinafter sometimes referred to as the debtor), and the losses claimed by the limited partners on their Federal income tax returns as a result of their investments in the debtor. Trial of these consolidated cases began on January 14, 1985.

Although the precise date is not in the record, the debtor filed a petition in bankruptcy sometime during 1977. On June 14, 1979, the Bankruptcy Court of the U.S. District Court for the Eastern District of North Carolina entered an order with respect to claims asserted in the bankruptcy proceeding by the Internal Revenue Service for unpaid employment taxes of the debtor for the years 1976, 1977, and 1978. For the sake of completeness and due to its brevity, we set out the entire text of that order:

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF NORTH CAROLINA

In the Matter of: Bankruptcy No.:

TUDOR ASSOCIATES, LTD., II,
A Nebraska Limited Partnership,
Debtor 77-06-BK-4

ORDER

THIS CAUSE coming on to be heard before the undersigned Bankruptcy Judge on the 31st day of October, 1978, at Raleigh, North Carolina, upon the objection by the Debtor to the claims of the Internal Revenue Service heretofore filed in this action; and it appearing that the Internal Revenue Service has appeared in this action and has filed claims against the Debtor as follows: (1) Claim #11, filed on the 23rd day of June, 1977, in the amount of $23,228.90, AMENDED; (2) Claim #13, filed on the 20th day of August, 1977, in the amount of $31,071.06, AMENDED; (3) Claim #27, filed on the 27th day of January, 1978, in the amount of $17,063.10; (4) Claim #48, filed on the 13th day of July, 1978, in the amount of $5,398.28; (5) Claim #49, filed on the 24th day of July, 1978, in the amount of $14,340.00; and it appearing, upon the representations of counsel, for the Debtor and for the Internal Revenue Service, that the parties have settled all matters of any

kind or nature in controversy and that the settlement is fair and reasonable and in the best interest of all creditors and other parties to this action and the partners of the Debtor; and it further appearing that such settlement represents an acknowledgement and payment by the Debtor for all withholding taxes, interest and other items due and payable to the Internal Revenue Service for the properties of the Debtor in Durham County, North Carolina, and a payment by the Debtor for all trust funds, withheld or otherwise due and payable by the Debtor on the Captain's Bridge property at Atlantic Beach, North Carolina; and for other good cause shown:

IT IS NOW, THEREFORE, ORDERED, ADJUDGED AND DECREED as follows:

1. That the Debtor shall pay to the Internal Revenue Service the sum of $22,941.39, in full and final satisfaction of all claims due from the Debtor to the Internal Revenue Service.

2. That the payment herein shall fully discharge the Debtor, Tudor Associates, Ltd., II, and its partners of all obligation and liability to the Internal Revenue Service by reason of their ownership of the subject properties and the partners' ownership of their interest in the Tudor Associates, Ltd., II from the time of acquisition of the properties to date with the exception only of taxes due by reason of returns not yet filed.

This the 14th day of June, 1979.

(S) Thomas M. Moore
THOMAS M. MOORE, *Bankruptcy Judge*

CONSENTED TO:

(S) George M. Anderson
GEORGE M. ANDERSON
United States Attorney

(S) Trawick H. Stubbs, Jr.
TRAWICK H. STUBBS, JR.
Attorney for Debtor

The uncontested affidavits submitted by respondent in connection with the pending motion establish that the enumerated claims set forth in the above order of the Bankruptcy Court pertain only to unpaid employment taxes of the debtor.

The instant motion for summary judgment is based on petitioners' contention that numbered paragraphs 1 and 2 of the order of the Bankruptcy Court determined petitioners' Federal income tax liabilities with respect to their investments in the debtor (namely, that the order affirmed the treatment by the limited partners, including petitioners herein, for Federal income tax purposes of various losses claimed on their respective Federal income tax returns). Respondent replies with the following arguments: First, that the June 14,

1979, order on its face does not pertain to the Federal income tax liabilities of the limited partners; second, that the order, at the most, pertained only to the Federal employment tax liabilities of the responsible employees of the debtor; and third, that the Bankruptcy Court under the circumstances of that particular proceeding could not appropriately have exercised jurisdiction over the Federal income tax liabilities of the limited partners and that it did not do so.

Prior to discussing the terms of the specific order in question, we will discuss the general jurisdiction of a bankruptcy court to determine Federal tax disputes with respect to the tax liabilities of individuals or entities other than the debtor. The applicable provision of the Bankruptcy Act[2] that grants to bankruptcy courts the jurisdiction to determine Federal tax liabilities, provides that bankruptcy courts shall—

> (2A) *Hear and determine*, or cause to be heard and determined, *any question arising as to* the amount or legality of any *unpaid tax*, whether or not previously assessed, which has not prior to bankruptcy been contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction, and in respect to any tax, whether or not paid, when any such question has been contested and adjudicated by a judicial or administrative tribunal of competent jurisdiction and the time for appeal or review has not expired, to authorize the receiver or the trustee to prosecute such appeal or review. [11 U.S.C. sec. 11(a)(2A); emphasis added.]

The above provision does not address whether the jurisdiction of the bankruptcy courts is limited to a determination of the Federal tax liabilities of the debtor or whether that jurisdiction also would include a determination of the Federal tax liabilities of individuals or entities other than the debtor in bankruptcy.

Although it appears still to be an open question, several courts have held that bankruptcy courts do have limited jurisdiction under the above statute (or under the applicable bankruptcy statute in effect when the respective petitions in bankruptcy were filed) to decide Federal tax liabilities in nondebtors, but only where those tax liabilities directly affect the debtor or his property. *In re Richmond v. United States*, 456 F.2d 458 (3d Cir. 1972). See also *O'Dell v. United States*,

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[2] 11 U.S.C. sec. 11(a)(2A) (as amended by Pub. L. 89-496 (1966), and as in effect for petitions filed in bankruptcy courts prior to Oct. 1, 1979). Present code sec. 505 of the Bankruptcy Reform Act of 1978, 11 U.S.C. sec. 505, only added stylistic changes to sec. 11(a)(2A) of the Bankruptcy Act.

326 F.2d 451 (10th Cir. 1964); *In re Driscoll's Towing Service, Inc. v. United States*, 43 Bankr. 647 (Bankr. S.D. Fla. 1984, 84–2 USTC par. 9940); *In re Datair*, 37 Bankr. 690 (Bankr. N.D. Ill. 1983, 53 AFTR 2d 84–1442, 84–1 USTC par. 9276); *In re Jon Co.*, 30 Bankr. 831 (D. Colo. 1983); *In re H & R Ice Co.*, 24 Bankr. 28 (Bankr. W.D. Mo. 1982); *In re Major Dynamics, Inc.*, 14 Bankr. 969 (Bankr. S.D. Cal. 1981, 49 AFTR 2d 82–1065, 81–2 USTC par. 9766). Those courts also have stated that only where "it is impossible to administer completely the estate of the [debtor] without determining [the tax] controversy" of nondebtors, may the bankruptcy court assert such jurisdiction (*O'Dell v. United States*, 326 F.2d at 455; *In re Datair*, 37 Bankr. at 696, 53 AFTR 2d at 84–1446, 84–1 USTC par. 9276, at 83,586; *In re H & R Ice Co.*, 24 Bankr. at 31; see also W. Collier, Bankruptcy, par. 505.04, at 505–26, 505–27 (15th ed. 1979)). Further, the mere "potential interference with the debtor's rehabilitation is too speculative to justify" an assertion of jurisdiction over Federal tax liabilities of nondebtors. *In re Major Dynamics, Inc.*, 14 Bankr. at 972, 49 AFTR 2d at 82–1066, 84–1 USTC par. 9766, at 88,553.

In *In re Richmond, supra*, the Bankruptcy Court determined that it was inappropriate to exercise jurisdiction to determine the Federal income tax liability of the debtor's wife who was not a party to the bankruptcy proceeding. The court reasoned that because the debtor and his wife had filed a joint return, they were jointly and severally liable for the taxes due. Accordingly, the Internal Revenue Service could proceed against either or both, and, therefore, the wife's tax liability was separate and distinct from that of the debtor. The Bankruptcy Court declined to exercise jurisdiction to determine the wife's tax liability "where the only connection between the dispute and the bankruptcy proceeding [was] that the outcome of the third-party controversy will in some way affect the debtor." 456 F.2d at 463–464.

One court has suggested that, regardless of how necessary the determination of the tax liabilities of other parties may be to the complete administration of the debtor's assets, a debtor in a bankruptcy proceeding will not have standing to litigate the Federal tax liabilities of other taxpayers without the active participation in the bankruptcy proceeding of the other taxpayers. *United States v. Rayson Sports, Inc.*, 44 Bankr. 280

(N.D. Ill. 1984, 54 AFTR 2d 84–6434, 84–2 USTC par. 9968). After mentioning a number of the cases we have cited previously herein, the court in *Rayson Sports* commented as follows:

> The fact that a corporation and [the other taxpayers] are entirely separate entities * * * seems to us dispositive of the standing issue; one entity simply cannot litigate the tax liabilities of the other. [54 AFTR 2d at 84–6435, 84–2 USTC par. 9968, at 85,964.][3]

Without deciding whether the Bankruptcy Court for the Eastern District of North Carolina would have had jurisdiction to determine the Federal income tax liabilities of the limited partners of Tudor Associates Ltd. II, and without deciding whether Tudor Associates Ltd. II would have had standing in the bankruptcy proceeding to litigate the Federal income tax liabilities of the limited partners, there is no indication herein that the Bankruptcy Court asserted jurisdiction over the Federal income tax liabilities of the limited partners who invested in Tudor Associates, Ltd. II. The order of the Bankruptcy Court enumerates specifically only the outstanding Federal employment tax liabilities of the debtor. No meaningful showing was made that that order constituted anything other than a mere consent order resulting from a settlement between representatives of the debtor and the Internal Revenue Service as to the amount of the unpaid employment taxes still owing by the debtor. Arguably, that order could be construed as a determination that the limited partners are not liable for the unpaid employment taxes of Tudor Associates, Ltd. II, but that question is not before us.

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[3] Where injunctive relief is requested in a bankruptcy proceeding against the audit or assessment activities of the Internal Revenue Service (which injunctive relief was not requested in the bankruptcy proceeding in question herein), the courts that have addressed the issue have split on whether the provisions of the Federal bankruptcy statute override the provisions of the Anti-Injunction Act, sec. 7421, I.R.C. 1954 as amended. For cases holding that the bankruptcy provisions override, see *Bostwick v. United States*, 521 F.2d 741, 744 (8th Cir. 1975); *In re Jon Co.*, 30 Bankr. 831, 834–835 (D. Colo. 1983); *In re H & R Ice Co.*, 24 Bankr. 23 (Bankr. W.D. Mo. 1982). To the contrary, see *Matter of Becker's Motor Transp., Inc.*, 632 F.2d 242, 246 (3d Cir. 1980), cert. denied 450 U.S. 916 (1981); *In re Pressimone*, 39 Bankr. 240, 246 (Bankr. N.D. N.Y. 1984). In *Becker's Motor Transp., Inc.*, the Third Circuit stated—

> "However persuasive the arguments against application of sec. 7421(a) to bankruptcy court adjudications may be, we believe that a bankruptcy court exemption cannot be judicially fashioned without contravening congressional intent. Although there may be some merit in permitting the policy behind the Bankruptcy Act to outweigh the rationale that underpins the anti-injunction legislation, such argument should be addressed to Congress. * * * [632 F.2d at 246.]"

The order certainly cannot be read as an adjudication of the limited partners' Federal income tax liabilities.

Furthermore, nothing in the record before us on this motion for summary judgment suggests that there would have been any justifiable reason for the Bankruptcy Court to determine the Federal income tax liabilities of the limited partners. There is no evidence to suggest that a failure to do so would have jeopardized the administration of the debtor's assets. There is no evidence to indicate that the Internal Revenue Service understood that the Bankruptcy Court was exercising jurisdiction over the Federal income tax liabilities of the individual limited partners, nor is there any evidence that the limited partners, themselves, understood that their individual Federal income tax liabilities were being determined by the Bankruptcy Court.

In light of the foregoing, petitioners' motion for summary judgment is denied.

An appropriate order will be issued.

MILTON J. SELIGMAN AND ESTATE OF FRANCINE SELIGMAN, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

FAYE S. HUTTON AND ESTATE OF C. HERBERT HUTTON, DECEASED, FAYE S. HUTTON, EXECUTRIX,[1] PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 16854–82, 17467–82. Filed February 12, 1985.

Petitioners purchased computer equipment packages for lease. The leases required petitioners to pay $225 each month for the first 12 months for lease administration services to be performed over the entire 41 months of the leases. *Held:* Petitioners cannot deduct the payments to M pursuant to sec.

[1]Faye S. Hutton and Estate of C. Herbert Hutton, Deceased, Faye S. Hutton, Executrix (the caption was changed on Aug. 27, 1982, in accordance with Rule 23(a)(1) of this Court's Rules of Practice and Procedure), docket No. 17467–82, was consolidated herewith for trial, briefing, and opinion.

162, I.R.C. 1954. Petitioners must capitalize these expenditures and amortize their cost over the entire lives of the leases. *Commissioner v. Lincoln Savings & Loan Association*, 403 U.S. 345 (1971), followed.

O. Jan Tyler and *Carl Abramson*, for the petitioners.
John W. Dierker, for the respondent.

GOFFE, *Judge*: The Commissioner determined deficiencies in the petitioners' Federal income taxes for the taxable years as follows:

Docket Nos.	*1978*	*1979*
16854–82	$21,583.14	$14,130.78
17467–82	11,842.85	

After concessions by the parties, the issue for decision is whether petitioners[2] are entitled to deduct under section 162[3] certain administrative leasing expenses paid in connection with their computer leasing activities.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and accompanying exhibits are so found and incorporated herein by reference.

Petitioners Milton Seligman and Faye Hutton resided in Texas when they filed their petitions. Each of these petitioners is the executor/executrix of the respective spouse's estate. For the taxable years 1978 and 1979, the Seligmans filed joint Federal income tax returns with the Internal Revenue Service Center in Austin, Texas. For the taxable year 1978, the Huttons filed a joint Federal income tax return with the Internal Revenue Service Center in Austin, Texas.

During the taxable years 1978 and 1979, petitioner Milton Seligman was employed as a manufacturer's representative. Francine Seligman, his wife, did not work during these years. During the taxable year 1978, C. Herbert Hutton was retired.

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[2] Although two of the petitioners are estates, we will use the term "petitioners," for purposes of simplicity, to refer both to the activities of the Seligmans and Huttons and their arguments on brief.

[3] All section references are to the Internal Revenue Code of 1954 and attendant regulations, as amended and in effect for the taxable years in issue and all Rule references are to this Court's Rules of Practice and Procedure.

Petitioner Faye Hutton, his wife, worked as a secretary/bookkeeper for the law firm of Sands & Tyler.

In 1976, Financial Marketing Services, Inc. (FMS), whose principal place of business is in Norcross, Georgia, was organized to engage in the business of buying and leasing computer equipment and selling equipment lease packages to investors. Jack Camarda (Camarda) is FMS's sole stockholder and previously was a financial marketing manager for Honeywell Information Systems, Inc. (Honeywell). In late 1977, FMS entered into negotiations with Best Products (Best) of Richmond, Virginia, concerning Best's use of Honeywell computer equipment. At that time, Best was leasing Honeywell computer equipment from FNC Leasing Co. (FNC), a wholly owned subsidiary of Fulton National Bank of Atlanta, and Citco Leasing Corp. (Citco), a wholly owned subsidiary of Citicorp Bank of New York. Best desired to upgrade its computer system and FMS wanted to purchase new Honeywell equipment and lease it to Best. Best, however, also desired to have FMS remove the unwanted Honeywell computer equipment and terminate Best's financial responsibility with respect to it.

During Camarda's employment with Honeywell, he became acquainted with O. Jan Tyler (Tyler), who is currently with the law firm of Sands & Tyler, because of Tyler's purchase and lease of Honeywell computer equipment to third parties. In 1976 and 1977, Tyler and Camarda worked together on several leveraged computer leasing transactions.

Omega Leasing Co. (Omega) is a Texas corporation which was initially organized as a partnership in 1971 and subsequently incorporated in 1973. During its partnership stage, it comprised five corporations, each having a 20-percent interest therein. Upon incorporation, each of the five corporations acquired a 20-percent equity interest in Omega. Since incorporation, Tyler has served as Omega's only president. Omega's business activities have included the purchase of Honeywell equipment and its leasing to third-party users. Prior to 1978, Omega also sold equipment lease packages.

Manmark Co. (Manmark), a corporation, was organized in 1975 to engage in the marketing and management of computer equipment leases. Tyler served as its president and acts as trustee for the beneficial owner of its stock, but he does not have, or claim, any beneficial ownership in any of its stock.

In early 1978, FMS began negotiating with Continental Trailways Bus System (Trailways) of Dallas, Texas, concerning its use of Honeywell computer equipment. Camarda desired to lease Best's unwanted Honeywell computer equipment to Trailways until Trailways acquired new equipment. Camarda contacted Tyler and proposed that an investor be found to purchase the computer equipment currently leased by Best from the two leasing companies and to lease the equipment to Trailways. The proposed sales price was approximately $2 million. Tyler felt difficulties would be encountered in locating a single investor who could purchase the $2 million package. Camarda then suggested that the equipment be divided into smaller packages for sale to numerous owners who would, in turn, lease the equipment to Trailways with FMS acting as an intermediary.

FMS eventually entered into contracts to purchase the Honeywell computer equipment currently leased by Best from FNC and Citco for a total purchase price of approximately $1,700,000. FMS then sold this equipment to Omega for $1,955,000, payable $255,000 in cash and $1,700,000 in nonrecourse promissory notes. The $1,700,000 indebtedness consisted of 17 notes of $85,000 each and one note of $255,000. FMS also divided the Honeywell computer equipment into 17 packages having a value determined by FMS of approximately $100,000 each and one package having a value of approximately $300,000.

Omega sold each $100,000 package to individual purchasers (including the Seligmans and Huttons) for a $15,000 cash downpayment and subject to $85,000 of the nonrecourse indebtedness to FMS. The $300,000 package was sold for a $45,000 cash downpayment and subject to $255,000 of the nonrecourse indebtedness to FMS. Monthly payments on each of the nonrecourse notes of $85,000 did not exceed $1,380.

Each equipment package purchaser entered into a 41-month equipment lease with FMS. Monthly lease payments of $1,460 were specified for each $100,000 equipment package. Further, according to the terms of the master equipment lease, each lessor also agreed "to pay Manmark Company a leasing commission and administrative handling fee in the amount of $225 a month for the first twelve [12] months of this lease."

The "leasing commission and administrative handling fee[s]" paid to Manmark by petitioners entitled them to miscellaneous administrative leasing services over the 41-month terms of the leases. Each month Manmark collected the lease payments and remitted the payments on the nonrecourse notes to FMS.[4] Each quarter Manmark remitted to petitioners the excess of the lease payments over the payments on the notes. Annually Manmark prepared and mailed tax information statements to petitioners indicating the total lease payments received, interest paid, administrative expenses incurred, and relevant depreciation information.

Petitioners reported these computer leasing activities on their joint Federal income tax returns as follows:

Petitioners	*Year*	*Income*	*Depreciation*	*Interest*	*Administrative expense*
Seligman	1978	$8,760	$21,248.00	$3,862.00	$1,350
	1979	17,520	17,732.58	7,087.04	1,350
Hutton	1978	8,760	7,142.85	3,862.19	1,350

For the taxable years 1978, the Seligmans and Huttons claimed $8,873.94 and $10,000, respectively, of investment tax credit concerning their respective $100,000 computer equipment packages that they purchased from Omega.

For the taxable year 1978, the Commissioner disallowed $954.90 of the $1,350 of administrative expense deductions claimed by the Huttons with respect to the $100,000 computer equipment package purchased from Omega. The Commissioner determined that such administrative fees "represent a capital expenditure and must be allocated over the 41 [month] term of the lease"; hence, only $395.10 of the deductions were permitted. The Commissioner also disallowed the $10,000 investment tax credit claimed by the Huttons because, as noncorporate lessors, they failed to satisfy the 15-percent test of section 1.46–4(d)(3), Income Tax Regs.

For the taxable years 1978 and 1979, the Commissioner disallowed the $1,350 of administrative expense deductions claimed by the Seligmans for each year because "it has not been established that any amount in excess of that allowed is an ordinary and necessary expense incurred or paid in the

[4] The record is unclear whether this facet of Manmark's administrative activities involved the actual exchange of funds with FMS or was merely accomplished by offsetting book entries.

production of income, was expended, or was expended for the designated purpose."[5] The Commissioner also disallowed the investment tax credit claimed by the Seligmans with respect to their $100,000 computer equipment package due to their failure to establish "any basis in any qualifying Section 38 property acquired and placed in service during 1978."

At trial, respondent sought leave to amend his answer in docket No. 16854–82 (Seligman) pursuant to Rule 41(a), and petitioners timely objected on general grounds. In the ensuing colloquy, respondent made the following representations concerning his proposed amendment:

> All the theory that is raised in the Seligman case by the new amendment to answer is already contained in the statutory notice on all of the cases. It is contained as an additional theory in two of the cases, but we are going to enter into stipulations regarding the disposition of four other cases, other than the ones that are being tried here this morning. And all of those cases will rely upon the Court's decision in the case in which this theory is raised in the statutory notice. That is the Hutton case.

This Court thereafter granted respondent leave to amend his answer over petitioners' objections. In his amended answer, respondent alleged "that allowable I.R.C. § 162 deductions for the first 12 months of the lease of the investment tax credit property do not exceed 15% of the rental income produced by such property during the first 12 months of the lease."

OPINION

The issue for decision is whether petitioners are entitled to deduct under section 162 certain administrative leasing expenses paid in connection with their computer equipment leasing activities. The determination of whether such expenses are deductible under section 162 or whether these expenses must be capitalized and amortized also directly affects petitioners' claimed investment tax credit because section 46(e)(3), which sets forth special limitations concerning noncorporate lessors, specifically provides that:

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[5] Respondent has apparently conceded in his briefs that these petitioners did, in fact, incur $1,350 of administrative expenses during the taxable years in issue.

(3) NONCORPORATE LESSORS.—A credit shall be allowed by section 38 to a person which is not a corporation with respect to property of which such person is the lessor only if—

(A) the property subject to the lease has been manufactured or produced by the lessor, or

(B) the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property, and for the period consisting of the first 12 months after the date on which the property is transferred to the lessee *the sum of the deductions with respect to such property which are allowable to the lessor solely by reason of section 162* (other than rents and reimbursed amounts with respect to such property) *exceeds 15 percent of the rental income produced by such property.*[6] [Emphasis added.]

In his opening brief, respondent asserts several alternate theories to support his position that petitioners are not entitled to the investment tax credit because they have failed to satisfy the requirements of section 46(e)(3)(B). First, respondent contends that petitioners' monthly payments to Manmark are not deductible under section 162 because petitioners failed to establish that these sums were paid in connection with the carrying on of a trade or business. For his second argument, respondent asserts that petitioners' monthly payments to Manmark are not allowable section 162 expenses "*with respect to*" the leased computer equipment as section 46(e)(3)(B) requires. Finally, respondent contends that "The administration fees, even if considered 'allowable section 162 expenses with respect to the leased property,' must be nonetheless allocated over the 41 month period of the lease because Manmark provided its services for this whole period."

Petitioners retort that respondent's first two contentions (i.e., allegations that petitioners were not involved in the carrying on of a trade or business or that the administrative expenses were not allowable 162 expenses "with respect to" the leased property) were first presented in respondent's opening brief as they were not raised in either the statutory notices mailed to petitioners or in the pleadings. In light of this procedural history, petitioners, claiming surprise, contend

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[6] As petitioners do not contend that they manufactured or produced the computer equipment they ultimately leased, they are entitled to investment tax credit only if they satisfy the requirements of sec. 46(e)(3)(B). The capitalization of the monthly administrative fees paid by petitioners to Manmark during the first 12 months of their leases and amortization over the 41-month terms of the leases under sec. 167 would effectively deny petitioners investment tax credit as they would be unable to satisfy the 15-percent test set forth in sec. 46(e)(3)(B).

that the Court should disregard such grounds, but if such grounds are considered, that respondent should bear the burden of proving them to be correct under Rule 142(a).

Although this Court possesses the inherent authority to sustain respondent's determination for reasons other than those assigned in his notice of deficiency (*Estate of Horvath v. Commissioner*, 59 T.C. 551, 555 (1973)), this should not be interpreted to afford respondent carte blanche authority to assert additional bases for his disallowance of specific items at any time prior to the issuance of an opinion. The common law practice of trial by surprise is an anathema to this Court. Rule 31(a) specifically provides that "The purpose of the pleadings is *to give the parties and the Court fair notice of the matters in controversy and the basis for their respective positions.*" (Emphasis added.)

Respondent is normally afforded as many as three distinct opportunities to assert specific reasons for the disallowance of deductions or credits on a Federal tax return. His initial option arises in the mailing of the notice of deficiency and his determinations therein are normally clothed with a presumption of correctness. *Welch v. Helvering*, 290 U.S. 111, 115 (1933). He may, in addition, assert new grounds for disallowance in his answer or in an amendment to his answer. Yet, as the U.S. Court of Appeals for the Eighth Circuit so aptly observed in *Commissioner v. Transport Mfg. & Equip. Co.*, 478 F.2d 731, 736 (8th Cir. 1973), affg. 57 T.C. 469 (1971), which involved a tardy assertion of a section 482 issue:

> the longer the Commissioner delays in not expressly advising the taxpayer of the intended theories, the more reason there is to conclude that the taxpayer has not received fair notice and has been substantially prejudiced so as to deny the Commissioner consideration of theories raised for the first time in post trial briefs. The Commissioner may avoid this uncertainty and discharge his duty of informing the taxpayer by expressly notifying the taxpayer of the intended theories in the deficiency notice and the Commissioner's answer.

It is not surprising, therefore, that this Court has consistently refused to consider issues first raised in the parties' briefs when surprise and prejudice are found to exist.[7] *Robertson v.*

[7] In the absence of surprise and prejudice, this Court will consider such matters. *Nat Harrison Associates, Inc. v. Commissioner*, 42 T.C. 601, 617 (1964).

Commissioner, 55 T.C. 862, 865 (1971); *Philbrick v. Commissioner*, 27 T.C. 346, 353 (1956); *Hettler v. Commissioner*, 16 T.C. 528, 535 (1951); *Wentworth Manufacturing Co. v. Commissioner*, 6 T.C. 1201, 1208 (1946).

In the instant case, petitioners were clearly surprised and prejudiced by respondent's attempt to assert in his opening brief two additional bases to support his disallowances of petitioners' claimed administrative expense deductions.[8] Respondent's post-trial contention that petitioners failed to establish that they were engaged in the trade or business of leasing computer equipment denied them the opportunity to present evidence on this issue because the pleadings did not alert them to this contention. The same can be said with respect to respondent's post-trial assertion that the claimed administrative expenses were not section 162 expenses "with respect to" the leased equipment. Further, raising new issues for the first time on brief also deprives the Court of complete argument and research of such contentions in the parties' opening and reply briefs. Accordingly, we will not consider these issues first raised in respondent's opening brief. *Robertson v. Commissioner*, *supra*; *Philbrick v. Commissioner*, *supra*; *Hettler v. Commissioner*, *supra*.

From these preliminary matters, we now turn to the ground for disallowance based upon capitalization. In docket No. 16854–82 (Seligman), respondent was granted leave to amend his answer to assert the disallowance position raised in docket No. 17467–82 (Hutton). Although the language in respondent's amended answer in docket No. 16854–82 (Seligman) disallowing the petitioners' administrative expense deductions differs from that set forth in the notice of deficiency in docket No. 17467–82 (Hutton), respondent now generally argues in both cases that petitioners' claimed administrative expense deductions should be capitalized and amortized over the 41-month terms of the computer leases.[9] In docket No. 16854–82 (Selig-

[8] Neither of the notices of deficiency or answers even tangentially raised these issues. Further, in respondent's representations to this Court at trial concerning his motion to amend his answer in docket No. 16854–82 (Seligman), he specifically stated that the amendment was only adding the capitalization issue set forth in the notice of deficiency in docket No. 17467–82 (Hutton).

[9] Although respondent is apparently willing to concede that the administration fees are allowable sec. 162 expenses which, nevertheless, must be allocated over the 41-month lease terms, *supra* at page 197, this proration argument differs materially from the capitalization issue. The proration of prepaid expenses to a subsequent taxable period necessarily requires the successful application of sec. 446(b), i.e., a determination that the taxpayer's method of accounting "does [not]

man), this constitutes a new matter; hence, respondent bears the burden of proving his position to be correct. Rule 142(a).

Petitioners contend that the fees paid by them to Manmark as administrative handling fees are deductible when paid pursuant to section 162. According to petitioners, these payments were scheduled to be made by each lessor during the time period Manmark contemplated that it would be rendering most of the services, and this was in accord with the custom, experience, and business practice of the industry. Further, these payments were made when Manmark, in fact, rendered most of the services to petitioners. Finally, citing several intangible drilling cost cases and revenue rulings, petitioners assert that although these fees are deductible when paid, on the ground that most of the services were then rendered, the presence of nominal services to be rendered in the future does not, per se, render them nondeductible.

In support of respondent's position that the 12 monthly administrative fees paid by petitioners to Manmark must be capitalized and amortized over the 41-month term of the computer equipment lease, he observes that Manmark's rendition of administrative services to petitioners extended over the entire term of the lease. Throughout the term of each lease, Manmark furnished investors quarterly statements setting forth lease income received and the payments on the debt. A check representing the amount of the excess income over loan repayments was also remitted to investors quarterly. Further, Manmark mailed annual letters to its investors setting forth applicable tax information. Although respondent concedes that some administrative duties during the early portion of the term of the lease were more extensive than those later performed, he argues that these additional duties were largely incidental to loan repayments and rendition of cash-flow

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clearly reflect income." *Van Raden v. Commissioner*, 71 T.C. 1083 (1979), affd. 650 F.2d 1046 (9th Cir. 1981). The attendant capitalization issue, on the other hand, concerns whether the expenditures constituted ordinary and necessary business expenses or created a capital asset. *Commissioner v. Lincoln Savings & Loan Association*, 403 U.S. 345 (1971). Sec. 446(b) imposes a burden of proof upon the taxpayer to demonstrate that the Commissioner abused his discretion in changing the taxpayer's accounting method. The burden on petitioner to prove that the Commissioner abused his discretion is heavy. *Resnik v. Commissioner*, 66 T.C. 74, 78 (1976), affd. 555 F.2d 634 (7th Cir. 1977). That burden of proof is heavier than merely proving that the determination of the Commissioner is erroneous. As petitioners were not alerted to respondent's assertion of the sec. 446(b) argument by either the notices of deficiency or pleadings and, therefore, presented no evidence or argument concerning this matter, we will not consider it. *Robertson v. Commissioner*, 55 T.C. 862, 865 (1971); *Philbrick v. Commissioner*, 27 T.C. 346, 353 (1956).

statements and quarterly statements which constituted a significant portion of Manmark's services in consideration for the 12 monthly payments of $225. In light of this record, respondent asserts that because the last lease payment benefited from the services as much as the first payment, the monthly fees paid by petitioners at the beginning of the 41-month lease should be allocated over the entire lease term. He also directs our attention to section 1.461–1(a), Income Tax Regs., which provides for the amortization of business expenses which result in the creation of an asset which has a useful life substantially in excess of 1 year. In the immediate cases, respondent asserts that the "asset" created is the right to certain administrative services over a 41-month term.

Although some courts and parties would have us believe otherwise, there is no precise line of demarcation separating business expenditures currently deductible under section 162(a) and those which constitute nondeductible capital expenditures within the scope of section 263. *Iowa-Des Moines Nat. Bank v. Commissioner*, 68 T.C. 872, 878 (1977), affd. 592 F.2d 433 (8th Cir. 1979); *Boagni v. Commissioner*, 59 T.C. 708, 712 (1973).

The principal function of the term "ordinary" in section 162(a) is to differentiate between expenditures which are currently deductible and those which are capital in nature. *Commissioner v. Lincoln Savings & Loan Association*, 403 U.S. 345, 353 (1971). Generally, expenditures to acquire assets or secure benefits which last beyond the taxable year must be capitalized. Sec. 1.263(a)–2(a), Income Tax Regs.; *United States v. Mississippi Chemical Corp.*, 405 U.S. 298, 310 (1972); *Central Texas Savings & Loan Association v. United States*, 731 F.2d 1181, 1183 (5th Cir. 1984); *Uecker v. Commissioner*, 81 T.C. 983, 995 (1983), on appeal (5th Cir., July 17, 1984); *Otis v. Commissioner*, 73 T.C. 671, 674 (1980), affd. without published opinion 665 F.2d 1053 (9th Cir. 1981). The mere presence of some possible future benefit from an expenditure, however, is not determinative. *Commissioner v. Lincoln Savings & Loan Association*, *supra* at 354.

When the immediate facts are reviewed in the context of these nebulous principles, the capital nature of petitioners' administrative expense payments to Manmark is quite apparent. These administrative expenditures, which were made by

both the Seligmans and Huttons over the first 12 months of the 41-month terms of the computer leases, created separate and distinct assets for petitioners, i.e., the right to have various administrative duties performed for them during the entire 41-month periods. *Commissioner v. Lincoln Savings & Loan Association, supra.* During the term of the lease, Manmark periodically collected lease payments from the lessee and made payments on the nonrecourse notes. Further, Manmark each quarter remitted to petitioners the difference between the lease income and payments on the notes. Finally, Manmark annually prepared and mailed to petitioners relevant tax information covering that year's computer equipment leasing activities. The fact that these expenditures created a separate and distinct intangible asset, i.e., the legally enforceable right to receive certain administrative services in the future, instead of a tangible asset, does not warrant a different conclusion. *Central Texas Savings & Loan Association v. United States, supra* at 1185.

Petitioners' contentions that their administrative expense payments to Manmark were scheduled during the time period that Manmark contemplated that it would be rendering most of the services and that most of Manmark's services were, in fact, rendered during the first 12 months of the 41-month computer equipment leases is not supported by the record. Mr. Tyler testified that computer equipment lessors frequently encounter difficulties in getting into the lessee's accounts payable routine in the early term of a lease. This problem, however, is largely imaginary in the instant setting because Mr. Tyler and the lessee, FMS, had worked closely together on several other computer equipment leasing transactions, and FMS's principal, Mr. Camarda, undoubtedly understood the necessity for prompt lease payments. Any additional services provided by Manmark only at the beginning of the term of the lease were clearly nominal and do not support the current deductibility of the administrative expenses when weighed against the recurring periodic administrative services provided over the entire 41-month period. Further, we found Mr. Tyler's testimony concerning the custom and practice of the computer leasing business to be evasive and entitled to little weight because of his pecuniary interest in the outcome of

these cases.[10] Petitioners' remaining witnesses, who were also in the computer leasing business, were no more convincing concerning the custom and practice of this business as some of them testified that they capitalized similar administrative expenses. Finally, petitioners' citation of cases and revenue rulings pertaining to intangible drilling costs is inapposite as these costs are admittedly capital in nature and are currently deductible only to the extent elected under section 263(c). *Sun Co. v. Commissioner*, 74 T.C. 1481 (1980), affd. 677 F.2d 294 (3d Cir. 1982); *Gates Rubber Co. v. Commissioner*, 74 T.C. 1456 (1980), affd. 694 F.2d 648 (10th Cir. 1982); *Standard Oil Co. (Ind.) v. Commissioner*, 68 T.C. 325 (1977). Accordingly, petitioners must capitalize the administrative expenses paid to Manmark and may recover their costs by amortizing them over the 41-month period of their computer equipment leases. Petitioners, therefore, also are not entitled to the investment tax credit with respect to their computer equipment packages as they have failed to satisfy the 15-percent requirement of section 46(e)(3).

Decision will be entered under Rule 155 in docket No. 16854–82.

Decision will be entered for the respondent in docket No. 17467–82.

INSULGLASS CORPORATION, WINTER SEAL OF FLINT, INC., JAMES NINOWSKI, JR., AND JUDITH NINOWSKI, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 19733–83. Filed February 13, 1985.

The notice of deficiency was issued more than 3, but less than 6, years after petitioners' 1976 return was filed. In a motion for partial summary judgment, petitioners contend that the 6-year statute under sec. 6501(e)(1)(A), I.R.C. 1954, does not apply. For purposes of the motion, petitioners concede that there were

[10] Mr. Tyler simultaneously served as president of both Omega and Manmark. Further, the law firm in which he was a member issued written opinions to investors expressing the view that the administrative expense payments were currently deductible and that the computer equipment lease packages entitled the investors to the investment tax credit.

items of gross income omitted from their 1976 return. *Held*: Petitioners' motion for partial summary judgment denied.

1. The fact that agents of respondent discovered the items of omitted income during the audit and prior to the expiration of the usual 3-year statute does not preclude respondent's resorting to the 6-year statute.

2. The fact that petitioners had reported some income from the source of one of the items of omitted income does not preclude such item of omitted income from being considered as such.

3. Petitioners, who were not in a trade or business of trading in commodities, reported gross proceeds from sales of commodities in the amount of $5,150,585.21 and capital gains of $202,202.69 therefrom. The capital gains, and not the gross proceeds, are to be treated as the "amount of gross income stated in the return" for purposes of sec. 6501(e).

Erwin A. Rubenstein and *Robert D. Kaplow*, for the petitioners.

Clyde W. Maudlin, for the respondent.

FEATHERSTON, *Judge*: This case was assigned to Special Trial Judge Randolph F. Caldwell, Jr., for the purpose of conducting the hearing and ruling on James and Judith Ninowski's motion for partial summary judgment. After a review of the record, we agree with and adopt his opinion which is set forth below.

OPINION OF THE SPECIAL TRIAL JUDGE

CALDWELL, *Special Trial Judge*: This case is presently before the Court on James and Judith Ninowski's (petitioners) motion for partial summary judgment filed on April 2, 1984, pursuant to Rule 121.[1]

Respondent determined the following deficiencies and additions to tax:

Year	*Deficiency*	*Additions to tax sec. 6653(a)*
1976	$396,787.14	$19,839.36
1977	460,295.44	23,014.77

[1] All references to Rules are to the Tax Court Rules of Practice and Procedure. Similarly, unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended.

The sole issue presented by petitioners' motion is whether petitioners omitted from gross income an amount in excess of 25 percent of the amount of gross income stated in their 1976 return, thereby invoking the 6-year statute of limitations provisions under section 6501(e)(1)(A).

Petitioners timely filed a joint Federal income tax return for the taxable year 1976 on or before April 15, 1977. In his notice of objection to petitioners' motion for partial summary judgment, respondent contends that the amount of gross income stated in the income tax return filed by petitioners for the taxable year 1976 was $628,295.92, consisting of the following:

(a) Wages	$414,000.00
(b) Interest income	1,748.65
(c) Commission income	10,000.00
(d) State income tax refund	344.58
(e) Capital gains from commodity transactions	[2]202,202.69
Total gross income on return	628,295.92

Petitioners attached a statement to their return indicating that the wages consisted of $364,000 earned from Winter Seal of Flint, Inc., and $50,000 from Insulglass Corp.

In addition, Mr. Ninowski owned 20 percent of the shares in a Subchapter S corporation called Cal Prix, Inc. (Cal Prix). On Schedule E attached to their return, petitioners reported a loss of $49,017 from Cal Prix. Petitioners included a statement with their return listing the amount of their loss and the name and employer identification number of Cal Prix. Cal Prix timely filed all necessary tax returns.

In addition, on Schedule D and Form 4797, petitioners reported transactions in commodities, with gross sales prices of $5,150,585.21. Petitioners reported $202,202.69 in capital gains from the commodities transactions, but an overall net loss of $226,811.52.

Respondent audited petitioners' 1976 and 1977 tax returns. Respondent determined that petitioners received additional income during 1976 from the following sources:

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[2]As discussed *infra*, petitioners take issue with respondent's determination of this amount, as well as other amounts.

(a) Wages from Winter Seal of Flint, Inc	$10,000.00
(b) Income - New Orleans Saints	100,000.00
(c) Other income from Winter Seal of Flint, Inc	270,030.05
Total	380,030.05

Respondent's agent discovered the foregoing omissions from income prior to the expiration of the 3-year limitation period prescribed by section 6501(a).

A notice of deficiency dated April 11, 1983, was issued to petitioners by respondent concerning the 1976 taxable year.

In their motion for partial summary judgment filed on April 2, 1984, petitioners argue that they are entitled to judgment as a matter of law because the 3-year statute of limitations has expired and the 6-year statute provided for in section 6501(e)(1)(A) does not apply. Respondent concedes that the 3-year statute does not apply, but argues that the 6-year statute under section 6501(e)(1)(A) does apply because the $380,030.05 of gross income allegedly received by petitioners in the taxable year 1976 and omitted from their return is in excess of 25 percent of $628,295.92, the gross income stated in their return. For purposes of this motion, petitioners concede that they received an additional $380,030.05 in gross income during 1976.

Section 6501(e)(1) provides in part:

> (A) GENERAL RULE.—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this subparagraph—
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> * * * * * * *
>
> (ii) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.

Petitioners make three arguments to support their position that section 6501(e)(1)(A) is inapplicable to the circumstances of this case and thus unavailable to lift the bar of the usual 3-year statute of limitations. First, petitioners argue that Congress' rationale in enacting section 275(c), I.R.C. 1939, the

predecessor of section 6501(e)(1)(A), was to provide respondent with additional time to investigate tax returns in situations where a taxpayer's omission of a taxable item puts respondent at a disadvantage in detecting errors. *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958). Therefore, according to petitioners, since respondent, by virtue of his audit, discovered the omitted items of income prior to the expiration of the 3-year statute, respondent was not at a disadvantage, and there is no reason to provide him with the benefit of an additional 3-year period to assess the tax.

Petitioners have not cited, nor has our own research disclosed, any cases to support their position concerning items disclosed during audit. Section 6501(e)(1)(A)(ii) provides that "there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is *disclosed in the return, or in a statement attached to the return.*" (Emphasis added.) The statute expressly refers to an amount disclosed in the return or in a statement attached to the return. It does not refer to knowledge of an omitted item of income gained by a revenue agent during an audit. We decline to adopt petitioners' position and thereby read more into the statute than was written by Congress.

We find support for our conclusion in *Houston v. Commissioner*, 38 T.C. 486 (1962), and *Goldring v. Commissioner*, 20 T.C. 79 (1953). These cases stand for the proposition that a taxpayer's filing of an amended return that includes in income amounts which had been omitted from the original return does not bar respondent's right to invoke the 6-year period provided in section 6501(e)(1)(A), based upon the omission from the original return, even though the amended return disclosed the previously omitted items. Although, in the instant case, disclosure occurred during the audit and not as a result of an amended return, such disclosure did occur subsequent to the filing of the original return; the disclosure was not made in the 1976 return, itself, or in a statement attached to the return. We see no meaningful distinction between disclosure occurring during an audit on the one hand, and disclosure through the filing of an amended return, on the other hand. Accordingly, we must reject petitioners' first argument.

Petitioners next argue that they did not omit an amount in excess of 25 percent of the amount of gross income stated in

their return because respondent was apprised of income received by Mr. Ninowski from Winter Seal of Flint, Inc. (Winter Seal), albeit not in the correct amount. Petitioners concede that they omitted $100,000 from the New Orleans Saints. Concerning the $280,030.05 from Winter Seal, however, petitioners argue that they merely made a mistake in reporting the amount of income received from Winter Seal. Petitioners argue that since they reported wages from Winter Seal on their return, and since they "supplied the Commissioner with adequate information to enable the Commissioner to investigate the amount of income received by the Petitioners from Winter Seal of Flint, Inc.," and since respondent did in fact conduct such an investigation, the $280,030.05 must be treated as not omitted from income under section 6501(e).

Petitioners offer no authority to support their argument. Whatever "information" petitioners did supply to respondent, they do not argue that it included disclosing the "nature and amount" of the items omitted in the return or in an attached statement, as required by the statute. Under these circumstances, respondent could not have been apprised of the omitted income.[3]

Petitioners' final argument concerns respondent's method of computing the amounts of gross income derived by petitioners from Cal Prix, a Subchapter S corporation, and their dealings in commodities transactions. Turning first to Cal Prix, petitioners argue that since Cal Prix filed a timely return, and since petitioners listed Cal Prix's name and employer identification number on a statement attached to their return, respondent was on notice as to the amount of petitioners' share of Cal Prix's gross income, $66,386.60. Petitioners argue it is this amount that should be treated as the gross income stated in the return in applying section 6501(e), not petitioners' reported loss of $49,017.

Petitioners make a similar argument with respect to the commodities transactions. Petitioners argue that in applying the 25-percent omission test of section 6501(e), the "amount of gross income stated in the return" includes the gross receipts from sales of commodities disclosed in their return. Therefore, according to petitioners, since they reported gross proceeds from sales of commodities of $5,150,585.21 on Schedule D and

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[3] See, e.g., *Thomas v. Commissioner*, T.C. Memo. 1973-261 ("To hold, as petitioners would have us do, that if a *type* of income is revealed in a tax return, there is sufficient disclosure, even though the amount is understated, would emasculate [section 6501(e)(1)(A)].").

Form 4797 attached to their 1976 return, this amount, not their reported capital gains of $202,202.69, should be treated as the "amount of gross income stated in the return" for purposes of section 6501(e). If petitioners' position is correct, the effect is to increase the gross income stated on their return by such an amount that even assuming they omitted $380,030.05 from income, it is still less than a 25-percent omission. Therefore, section 6501(e) would not apply.

As both parties acknowledged at the hearing, the success of petitioners' motion hinges not on the proper amount of gross income attributable to Cal Prix, but on the amount of gross income attributable to petitioners' commodities transactions. Accordingly, we need not address petitioners' arguments regarding Cal Prix.

Turning to petitioners' commodities transactions, petitioners argue that under section 6501(e)(1)(A)(i), $5,150,585.21 should be included in income for purposes of section 6501(e)(1)(A).[4] This is the "total of the amounts received * * * from the sale of" the commodities options, i.e., the amount of the gross proceeds petitioners derived as investors in trading options on the London metal exchange.

To support their position, petitioners rely on *Connelly v. Commissioner*, T.C. Memo. 1982–644. In *Connelly*, the Court found that the taxpayer's husband was engaged in the trade or business of selling and purchasing stock, and that the husband derived all his income from these activities. Therefore, under section 6501(e)(1)(A)(i), the Court held that gross proceeds from the sale of stock was the proper figure to use for computing gross income for purposes of applying the 25-percent test. Nevertheless, the Court stated in note 7:

> Our utilization of the gross receipts test on the basis of our conclusion that [the taxpayer's husband] was engaged in a trade or business and was not simply an investor is not intended to imply that if he had fallen into the latter category, the gross receipts test would necessarily not be applied in view of the broad sweep of section 6501(e)(1)(A), see *Estate of Klein v. Commissioner*, 63 T.C. 585 (1975), affd. 537 F.2d 701 (2d Cir. 1976); *Roschuni v. Commissioner*, 44 T.C. 80 (1965).

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[4] Sec. 6501(e)(1)(A)(i) provides: "In the case of a trade or business, the term 'gross income' means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and * * *."

Although the Court stated in the cited footnote that it was not deciding that in the case of an *investor* the gross receipts test would necessarily *not* be applied, the Court did not state that it necessarily *should* be applied.

In our view, section 6501(e)(1)(A)(i) provides an exception—in the case of a trade or business—to the general meaning of "gross income" as stated in section 6501(e). In the case of a trade or business, "gross income" is equated with gross receipts. Otherwise, "gross income" means those items listed in section 61(a), which includes, among other things, gains derived from dealings in property.[5] Sec. 61(a)(3).

In the instant case, petitioners' gains derived from dealings in commodities were $202,202.69. It is this amount which is the gross income stated in the return for purposes of section 6501(e).[6] See *Burbage v. Commissioner*, 82 T.C. 546, 558 (1984); *Roschuni v. Commissioner*, 44 T.C. 80, 83 (1965).

Accordingly, since petitioners failed to report $380,030.05, which amount is in excess of 25 percent of the reported gross income,[7] assessment of the deficiency is not barred under section 6501(e)(1)(A), and petitioners' motion should be denied.

An appropriate order will be issued.

WILLIAM F. SUTTON AND HELEN C. SUTTON, ET AL.,[1] PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 22131–81,
22639–81 (Nitrol Issues),
28537–81,
13350–82,
18891–82,
3114–83.

Filed February 13, 1985.

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[5] See *Carr v. Commissioner*, T.C. Memo. 1978–408, 37 T.C.M. 1695, 1703, 47 P-H Memo T.C. par. 78,407, at 1685.

[6] We do not address respondent's alternative contention that petitioners' commodities gains and losses should be offset, and that petitioners' thus had no gains from dealings in commodities under sec. 61(a)(3).

[7] The omission would exceed 25 percent of reported gross income even if we were to accept petitioners' position with respect to Cal Prix.

[1] Cases of the following petitioners are consolidated herewith: John F. Knowlton and Betty W. Knowlton, docket No. 22639–81 (Nitrol Issues); Joseph W. Fleece, Jr., and Joanne M. Fleece, docket No. 28537–81; John C. Pruitt and Frances M. Pruitt, docket No. 13350–82; Jules Dressler and

Ps claimed losses in connection with the ownership of specially equipped refrigerated highway freight trailers. *Held*, Ps may not deduct the claimed losses since they did not engage in the activities for profit within the meaning of sec. 183, I.R.C. 1954.

B. Gray Gibbs, for the petitioners.
Andrew M. Winkler, for the respondent.

NIMS, *Judge*: In these consolidated cases, respondent determined the following deficiencies in petitioners' Federal income taxes:

Docket No.	*Petitioner*	*Year*	*Deficiency*
22131–81	William F. Sutton and Helen C. Sutton	1977	$62,616.00
		1978	60,127.00
22639–81	John F. Knowlton and Betty W. Knowlton	1977	61,924.00
		1978	63,281.00
28537–81	Joseph W. Fleece, Jr., and Joanne M. Fleece	1975	13,784.00
		1976	9,200.00
		1977	108,792.00
		1978	69,457.00
		1979	97,811.00
13350–82	John C. Pruitt and Frances M. Pruitt	1976	44,301.10
		1977	101,453.70
		1978	74,268.70
		1979	17,446.18
18891–82	Jules Dressler and Muriel Dressler	1978	2,084.00
3114–83	R. Huston Babcock and Suzanne Babcock	1977	52,247.00
		1978	39,366.00
		1979	45,787.00

One of the issues in docket No. 22639–81 was severed from this consolidated case and is the subject of a separate opinion by Judge Tannenwald reported at 84 T.C. 160 (1985). Judge Nims did not participate in the trial or opinion with regard to the severed issue. Judge Tannenwald's disposition of the

Muriel Dressler, docket No. 18891–82; R. Huston Babcock and Suzanne Babcock, docket No. 3114–83.

severed issue will be incorporated into the Rule 155 computation required in docket No. 22639–81.

Due to concessions, the issues for decision are: (1) Whether petitioners' Nitrol Program activities were engaged in for profit within the meaning of section 183; and (2) whether certain nonrecourse notes may be included in the basis of the specially equipped refrigerated highway freight trailers acquired by petitioners.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Petitioners Joseph W., Jr., and Joanne M. Fleece, husband and wife, John C. and Frances M. Pruitt, husband and wife, John F. and Betty W. Knowlton, husband and wife, and R. Huston and Suzanne Babcock, husband and wife, resided at St. Petersburg, Florida, at the time their respective petitions were filed. Petitioners William F. and Helen C. Sutton, husband and wife, resided at Tampa, Florida, at the time their petition was filed. Petitioners Jules and Muriel Dressler, husband and wife, resided at Ft. Lauderdale, Florida, at the time their petition was filed.

For convenience, William F. Sutton, Betty W. Knowlton, Joseph W. Fleece, Jr., John C. Pruitt, R. Huston Babcock, and Jules Dressler will sometimes hereinafter be referred to as petitioners.

During the years in issue, petitioners were employed as follows:

Petitioner	*Profession*
Sutton	Executive
Knowlton	Hotel manager
Fleece	Attorney
Babcock	Physician
Pruitt	Physician
Dressler	Executive

In December 1977, petitioners invested in a program (the Nitrol Program) offered by two California corporations, Nitrol Corp. (Nitrol) and Transit Management Co. (TMC). Under the program, investors purchased refrigerated highway freight

trailers equipped with "controlled atmosphere units" from Nitrol and entered into a trailer management agreement with TMC. For convenience, we will hereinafter refer to the controlled atmosphere units as the Nitrol units and the refrigerated highway freight trailers equipped with the Nitrol units as the Nitrol trailers.

Sutton, Knowlton, and Babcock each purchased one Nitrol trailer. Fleece and Pruitt each purchased two Nitrol trailers. Dressler owned a limited partnership interest in Overnite, Ltd., a limited partnership formed to purchase one Nitrol trailer. For purposes of this opinion, reference to the term "petitioners" for convenience also sometimes refers to Overnite, Ltd., and/or the general partner of that partnership.

David Dixon, a mechanical engineer, designed the Nitrol unit to produce a low-oxygen environment within the interior compartment of a standard refrigerated highway freight trailer. He worked from 1966 to 1968 developing the Nitrol unit. In June 1976, he received a patent (the 477 Patent) for the Nitrol unit.

The Nitrol unit consisted of an insulated storage tank filled with liquid oxygen and nitrogen mounted on the chasis of a refrigerated highway freight trailer. As the liquid vaporized, gases entered the trailer compartment through metal tubes leading from the tank to the compartment, producing a low-oxygen environment within the interior of the trailer.

Studies conducted during the early 1960's by Dixon concluded that perishable commodities shipped in a low-oxygen environment would generally remain fresher than if shipped in a standard refrigerated truck. From the mid-1960's to the mid-1970's, several companies attempted to market trailers designed to transport perishable commodities in a low-oxygen environment. The unprofitability of the venture, however, forced each company to abandon the project.

Sometime during early 1977, Dixon, Steven Lewis (Lewis), James Power (Power), and Dorman Dimmitt (Dimmitt) joined together to develop the Nitrol Program to economically exploit the 477 Patent. Power incorporated Nitrol on June 3, 1977, to construct approximately 100 Nitrol trailers. Dimmitt, who had managed several trucking companies prior to his association with the Nitrol Program, incorporated TMC on July 11, 1977,

to manage the Nitrol trailers sold by Nitrol. Dimmitt also became the chief operating officer of TMC.

Subsequent to the incorporation of Nitrol, Dixon and Lewis transferred an exclusive license under the 477 Patent to Nitrol. Nitrol agreed to pay Dixon and Lewis 70 percent of the net profits realized from the sale of Nitrol trailers. Power, as Nitrol's sole shareholder and chief operating officer, effectively retained 30 percent of Nitrol's profits.

Following the receipt of the exclusive license, Nitrol purchased 100 refrigerated highway freight trailers from Sierra Truck & Trailer Sales, Inc. (Sierra), for $27,500 per trailer. Nitrol financed the purchase of the trailers with Hobbs Corp. (Hobbs), the manufacturer of the trailers. Hobbs retained a security interest in each trailer sold. Although Nitrol was primarily liable on the installment contracts, all Nitrol Program investors were given the right to cure any default on the installment contracts.

Nitrol also contracted with Gibson Cryogenics to construct approximately 100 Nitrol units pursuant to Dixon's specifications. Nitrol paid approximately $2,430 for the manufacture and installation of each Nitrol unit.

Petitioners first learned of the Nitrol Program from their accountants and attorneys in November 1977. In December 1977, after reviewing a private placement memorandum detailing the Nitrol Program and discussing the investment with their accountants and attorneys, petitioners invested in the Nitrol Program. Neither petitioners nor their advisers had previous experience in the trucking industry.

Petitioners purchased each Nitrol trailer for $275,000, the consideration consisting of a $27,500 cash downpayment and a nonrecourse promissory note in the amount of $247,500. Agreements executed contemporaneously with the nonrecourse notes provided that the total purchase price of $275,000 was allocable as follows: $32,500 to the trailer and $242,500 to the Nitrol unit.

Petitioners entered into 10-year trailer management agreements with TMC contemporaneously with the purchase of the Nitrol trailers. Pursuant to these agreements, TMC agreed to solicit and negotiate freight contracts with shippers on behalf of petitioners. Dimmitt intended to contract with produce growers shipping perishable commodities from the west coast

to the east coast. For the return trip from the east coast, however, Dimmitt intended to lease the trailers to a common carrier under a trip leasing agreement.[2] Dimmitt anticipated that the common carriers would ship nonperishable commodities and thus would not utilize the Nitrol process.

In addition, TMC agreed to: (1) Locate tractors and drivers to pull petitioners' Nitrol trailers; (2) maintain books and records of the receipt and disbursement of money received pursuant to the freight contracts; (3) repair and maintain petitioners' Nitrol trailers; and (4) furnish petitioners with quarterly reports of income and expenses from the trailers' operation. In effect, TMC agreed to perform all functions necessary to maintain and operate petitioners' Nitrol trailers.

In return, petitioners agreed to pay TMC an initial management fee of $2,000 per trailer plus 3 percent of the gross revenues earned from the operation of each trailer. Petitioners also contributed operating capital of $12,500 per trailer to TMC in 1977.

The private placement memorandum provided that the Nitrol trailers were expected to generate sufficient revenues to pay all operational expenses, the amounts due under the terms of the notes, and return a pre-tax profit of $152,279 per trailer. This projection was based on each trailer's making three coast-to-coast round trips of 5,600 miles per month for 12½ years.

Each trailer was expected to earn an average of $0.86 per revenue mile. The revenue per mile rate did not reflect a premium for shipments utilizing the controlled atmosphere system. Rather, Dixon and Dimmitt computed total revenue miles on the assumption that the benefits of the controlled atmosphere system would increase the demand for petitioners' Nitrol trailers.

In addition to the projected profit, the private placement memorandum informed potential investors that an investment in the Nitrol Program would produce operating loss deduction equivalents during the first 3 years of the investment equal to approximately 517 percent of petitioners' initial

[2]Pursuant to regulations promulgated by the Interstate Commerce Commission, only common carriers were authorized to carry commodities regulated by the ICC. TMC was not a common carrier and thus was allowed to carry only commodities the ICC classified as exempt, such as produce. By engaging in trip leasing with common carriers, however, TMC was allowed to transport regulated commodities on the return trip from the east coast.

cash investment of $40,000. The private placement memorandum stated, however, that any gain realized on the disposition of the trailer would constitute ordinary income to the extent of all depreciation deductions previously claimed by the owner. Moreover, if the disposition occurred within 7 years from the date of acquisition, part or all of the investment tax credit previously claimed would be recaptured from the investor.

Petitioners purchased the Nitrol trailers through Lee Puckett (Puckett), a St. Petersburg, Florida, investment broker engaged in the marketing of tax shelters. Puckett received a $4,000 commission for each Nitrol Program package he sold. This represented 10 percent of the total cash outlay of $40,000 per trailer.

Puckett became familiar with the Nitrol Program in August 1977. Prior to presenting the investment to petitioners, Puckett hired John Kearney (Kearney), an accountant, and Richard Jacobs (Jacobs), an attorney, to assist him in an analysis of the investment. Neither Puckett, Kearney, nor Jacobs had previous experience in the trucking industry.

Puckett, Kearney, and Jacobs traveled to California and spent 4 days investigating the Nitrol Program. During the course of the investigation, they: (1) Met with Dimmitt, Power, and Dixon to discuss the Nitrol Program, including the projections of revenues and expenses contained in the private placement memorandum; (2) met with representives of the accounting firm and law firm hired by Dixon to prepare the disclosure memorandum; and (3) received testimonials confirming the performance of the Nitrol unit. Following their investigation, Puckett decided to market the Nitrol Program.

TMC began operating petitioners' Nitrol trailers in January 1978. The Nitrol trailers' lack of profitability became immediately apparent. In September 1978, Puckett, Kearney, and Jacobs traveled to California to further discuss the operation of petitioners' Nitrol trailers with Dimmitt and Power. The reasons they received for the Nitrol trailers' lack of profitability included the following: (1) The difficulty in obtaining owner-operators with tractors to pull the Nitrol trailers; (2) the downturn in the economy following commencement of trailer operations; and (3) the severe weather in the Northeast and a rainy season in California during the winter of 1977–78.

As a result of the trailers' unprofitability, TMC was unable to make payments on petitioners' nonrecourse notes held by Nitrol. Consequently, Nitrol was unable to satisfy the amounts due on the Hobbs installment contracts. In September 1978, Kearney, Jacobs, and Puckett negotiated an amendment to petitioners' nonrecourse notes which required petitioners to make payments from October 31, 1978, to January 31, 1983, only to the extent of income earned by the Nitrol trailers.

By letter dated September 9, 1978, Puckett informed petitioners of TMC's need for additional working capital. He concluded the letter as follows:

> I recognize no one wants to contribute capital but;
> (A). There are about $70,000 to $80,000 of estimated deductions available this year if the trailer keeps operating. Capital will do it.
> (B). If the trailer does not operate and foreclosure results you will have substantial recapture of prior losses—perhaps as much as $100,000 of taxable income.
> Thus, it appears prudent to consider making a reasonable capital advance* * *

Petitioners, except for Overnite, Ltd., subsequently contributed $8,000 per trailer to TMC's operating capital. Overnite, Ltd., contributed $3,920.

By letters dated April 3, 1979, and May 10, 1979, Hobbs notified petitioners that Nitrol was in default on the Hobbs installment contracts. In response, petitioners retained Jacobs and Kearney to determine the status of the Nitrol Program. Following an investigation, Jacobs and Kearney recommended that petitioners satisfy the outstanding balance due on the Hobbs installment contracts. Pursuant to these recommendations, petitioners, except for Dressler and Overnite, Ltd., satisfied the outstanding balances as follows:

Petitioner	*Date credited by Hobbs*	*Balance due (paid off)*
Sutton	9/29/79	$13,015.86
Knowlton	10/31/79	12,637.81
Fleece	9/29/79	27,017.37
Pruitt	9/26/79	25,056.97
Babcock	9/26/79	13,543.56

Overnite, Ltd., refinanced the $26,865 balance then due Hobbs.

As a result of petitioners' payment of the balance due on the installment contracts, Nitrol amended petitioners' nonrecourse notes a second time as follows: (1) The outstanding principal balance due on the note ($247,500) would be reduced by the amount each petitioner paid to Hobbs; and (2) subsequent payments on the notes would be suspended until January 1, 1983.

On September 4, 1979, petitioners terminated the TMC management agreement and, except for Dressler and Overnite, Ltd., entered into a transportation management agreement with Road West Co. (Road West), a California corporation. Road West agreed to distribute gross revenues received from the shipping contracts as follows: 70 percent to the tractor owner, 10 percent to the trailer owner, and 20 percent to Road West.

In September 1979, pursuant to the recommendation of Richard Goodin, president of Road West, petitioners, except for Dressler and Overnite, Ltd., entered into installment contracts to purchase highway tractors for $41,400 per tractor. Goodin believed the lack of owner-operators to pull petitioners' Nitrol trailers was the major reason for the trailers' unprofitability.

Petitioners' Nitrol trailers nonetheless continued to sustain losses under Road West's management. Road West eventually removed the Nitrol units from petitioners' trailers.

In the spring of 1983, petitioners sold the tractors and terminated the Road West management agreement. They arranged to lease the trailers (without the Nitrol units) to Road West for a monthly rental of $315.

During the period of the Road West management agreement, petitioners made contributions to Road West's working capital, including amounts due on petitioners' tractors, as follows:

Petitioner	*Amount*
Fleece	$81,278.20
Knowlton	63,737.20
Sutton	25,895.97
Pruitt	11,500.00
Babcock	11,500.00

From 1977 to 1982, petitioners claimed investment credits and operating loss deductions with respect to the Nitrol trailers as follows:

Petitioner	*Year*	*Investment credit*	*Loss*
Sutton	1977	$27,500	$50,217
	1978		85,959
	1979		71,710
	1980		54,345
	1981		[1]11,775
	1982		[2]10,704
		Total	284,710
Knowlton	1977	27,500	49,237
	1978		78,800
	1979		70,146
	1980		49,637
	1981		[3]24,131
	1982		[4] 0
		Total	271,951
Fleece	1977	55,000	95,186
	1978		161,885
	1979		136,009
	1980		97,064
	1981		[5]75,886
	1982		[6] 0
		Total	566,030
Pruitt	1977	55,000	97,408
	1978		164,873
	1979		134,542
	1980		97,504
	1981		74,657
	1982		71,552
		Total	640,536
Babcock	1977	27,500	49,494
	1978		81,098
	1979		65,163
	1980		33,185
	1981		27,381
	1982		36,878
		Total	293,199
Overnite, Ltd.	1977	27,500	15,558
	1978		82,912
	1979		55,481

Petitioner	Year	Investment credit	Loss
	1980		$30,215
	1981		30,215
	1982		30,215
		Total	244,596

[1]Sutton's Nitrol trailer realized an actual loss of $34,159 during 1981. The "at risk" limitations of sec. 465 limited Sutton's deduction to $11,775.
[2]Sutton's Nitrol trailer realized an actual loss of $34,842 during 1982. The "at risk" limitations of sec. 465 limited Sutton's deductions to $10,704.
[3]Knowlton's Nitrol trailer realized an actual loss of $37,859 during 1981. The "at risk" limitations of sec. 465 limited Knowlton's deduction to $24,131.
[4]Knowlton's Nitrol trailer realized an actual loss of $17,916 during 1982. The "at risk" limitations of sec. 465 limited Knowlton's deduction to 0.
[5]Fleece's Nitrol trailer realized an actual loss of $95,729 during 1981. The "at risk" limitations of sec. 465 limited Fleece's deduction to $75,886.
[6]Fleece's Nitrol trailer realized an actual loss of $29,144 during 1982. The "at risk" limitations of sec. 465 limited Fleece's deduction to 0.

During the years in issue, petitioners reported taxable income (before claiming the Nitrol loss deductions) on their Federal income tax returns as follows:

Petitioner	Year	Taxable income
Sutton	1977	$1,004,301
	1978	702,171
Knowlton	1977	417,780
	1978	455,561
Fleece	1977	292,157
	1978	135,917
	1979	140,392
Babcock	1977	131,925
	1978	86,872
	1979	128,223
Pruitt	1977	625,385
	1978	362,247
	1979	111,407

In his notice of deficiency, respondent allowed petitioners' claimed loss deductions to the extent permitted by section 183[3] for the years at issue. Respondent fully disallowed the investment credits claimed by petitioners in 1977.

[3]Unless otherwise indicated, all section references are to sections of the Internal Revenue Code of 1954 in effect for the years in question.

OPINION

Respondent argues that petitioners are not entitled to the claimed losses and investment credits because they did not engage in the Nitrol Program for profit within the meaning of section 183. In the event we find that petitioners did possess the requisite profit motive, respondent argues in the alternative that petitioners' basis in the Nitrol trailers should not include the $247,500 nonrecourse notes for the following reasons: (1) The notes are contingent and speculative, and (2) the amount of each nonrecourse note unreasonably exceeds the fair market value of each Nitrol trailer. For the reasons stated below, we agree with respondent that petitioners' Nitrol program activities were not engaged in for profit within the meaning of section 183. Accordingly, we need not address respondent's alternative arguments.

A taxpayer[4] must engage in an activity with the primary purpose and objective of making a profit in order to fully deduct expenses under either section 162 or section 212 (*Golanty v. Commissioner*, 72 T.C. 411, 425 (1979), affd. without published opinion 647 F.2d 170 (9th Cir. 1981)) and to claim investment credits under section 38. *Pike v. Commissioner*, 78 T.C. 822, 841–842 (1982). "While a reasonable expectation of profit is not required, the taxpayer's profit objective must be bona fide." *Fox v. Commissioner*, 80 T.C. 972, 1006 (1983), affd. by order 742 F.2d 1441 (2d Cir. 1984), affd. sub nom. *Barnard v. Commissioner*, 731 F.2d 230 (4th Cir. 1984), affd. without published opinion sub nom. *Kratsa v. Commissioner*, 734 F.2d 6 (3d Cir. 1984), affd. without published opinion sub nom. *Hook v. Commissioner*, 734 F.2d 5 (3d Cir. 1984); *Dreicer v. Commissioner*, 78 T.C. 642, 644–645 (1982), affd. without opinion 702 F.2d 1204 (D.C. Cir. 1983).

The issue of whether a taxpayer engages in an activity with the requisite objective of making a profit is one of fact to be resolved on the basis of all the facts and circumstances. *Lemmen v. Commissioner*, 77 T.C. 1326, 1340 (1981). The burden of proving the requisite intention is on petitioners. *Sabelis v. Commissioner*, 37 T.C. 1058, 1062 (1962); Rule 142(a).

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[4] For purposes of determining whether Dressler is entitled to claim loss deductions and an investment credit in excess of the amount allowed by respondent, the intent of Overnite, Ltd., is controlling. *Fox v. Commissioner*, 80 T.C. 972 (1983).

Section 183 allows deductions for ordinary and necessary expenses arising from an activity not engaged in for profit only to the extent of gross income derived from such activity, less the amount of those deductions which are allowable regardless of whether or not the activity is engaged in for profit.[5]

Section 1.183–2(b), Income Tax Regs., lists some of the relevant factors to be considered in determining whether an activity is "not engaged in for profit." These factors include: (1) The manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisers; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved.

Petitioners testified at trial that they would not have invested in the Nitrol Program unless they intended to make an economic profit. We must, nevertheless, give greater weight to objective factors than to petitioners' mere statement of intent. Sec. 1.183–2(a), Income Tax Regs. Accordingly, for the

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[5]Sec. 183 reads, in relevant part, as follows:

SEC. 183(a). GENERAL RULE.—In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

(b) DEDUCTIONS ALLOWABLE.—In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed—

(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

(c) ACTIVITY NOT ENGAGED IN FOR PROFIT DEFINED.—For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

(d) PRESUMPTION.—If the gross income derived from an activity for 2 or more of the taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity (determined without regard to whether or not such activity is engaged in for profit), then, unless the Secretary establishes to the contrary, such activity shall be presumed for purposes of this chapter for such taxable year to be an activity engaged in for profit. In the case of an activity which consists in major part of the breeding, training, showing, or racing of horses, the preceding sentence shall be applied by substituting the period of 7 consecutive taxable years for the period of 5 consecutive taxable years.

reasons set forth below, we are convinced that petitioners intended to make a tax profit, not an economic profit, when they invested in the Nitrol Program.

First, we do not believe that petitioners would have agreed to pay $275,000 for each Nitrol trailer if they had been concerned with the economic profitability of the investment. The record contains no evidence which convinces us that petitioners believed the economic potential of each Nitrol trailer would support a $275,000 purchase price. TMC did not intend to charge a premium for shipments utilizing the Nitrol process. In addition, TMC anticipated that the trip-leasing arrangements from the east coast to the west coast would generally involve nonproduce items which would realize no benefits from the Nitrol process. Nevertheless, the Nitrol trailer's purchase price approximated the cost of 10 standard refrigerated trailers. Moreover, the portion of the purchase price allocated to each Nitrol unit ($247,500) equaled more than 100 times the construction cost of each Nitrol unit.

Conversely, a $275,000 basis in each Nitrol trailer would generate a substantial tax profit. The disclosure memorandum stated that a $40,000 investment in the Nitrol Program would alone give rise to tax deduction equivalents of approximately $206,800 in the first 3 years of the investment. A 50-percent tax bracket taxpayer would realize tax benefits of approximately $103,400. Thus, in the first 3 years of their investment, petitioners anticipated tax savings in excess of 250 percent of each $40,000 cash investment.[6]

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[6]The relevant tax rates applicable to taxable income on joint returns during the years in issue were as follows:

Taxable income	
1977–78	
Over $67,200 – $79,200	55 percent
Over 79,200 – 91,200	58 percent
Over 91,200 – 103,200	60 percent
Over 103,200 – 123,200	62 percent
Over 123,200 – 143,200	64 percent
Over 143,200 – 163,200	66 percent
Over 163,200 – 183,200	68 percent
Over 183,200 – 203,200	69 percent
Over 203,200	70 percent
1979	
Over 60,000 – 85,600	54 percent
Over 85,600 – 109,400	59 percent
Over 109,400 – 162,400	64 percent

Moreover, petitioners manufactured the high basis and corresponding tax benefits through the use of large nonrecourse financing. The percentage of the purchase price financed with nonrecourse notes (90 percent), in combination with the large purchase price agreed to by petitioners, is strong evidence that the potential tax profit, and not the potential economic profit, motivated petitioners' investment in the Nitrol Program. See *Fox v. Commissioner, supra.*

Petitioners claim that the profit projections contained in the private placement memorandum support the Nitrol trailer's $275,000 purchase price. Petitioners' cursory investigation of the profit projections prior to investing in the Nitrol Program, however, is further evidence that petitioners were not concerned with the investment's profit potential. *Estate of Baron v. Commissioner*, 83 T.C. 542 (1984). Neither petitioners nor the advisers they contacted prior to investing in the Nitrol Program possessed sufficient knowledge of the trucking industry to independently verify the profit projections contained in the private placement memorandum. Furthermore, neither petitioners nor their advisers contacted independent experts to verify the reasonableness of the profit projections.

Petitioners argue that they relied on the investigations conducted by Puckett, Kearney, and Jacobs. We are not, however, persuaded by this argument. Neither Puckett, Kearney, nor Jacobs was qualified to independently evaluate the profit projections contained in the private placement memorandum. Moreover, the three men made no effort to discuss the profit potential of the investment with independent experts, including the companies which had previously attempted to market controlled atmosphere trailers. They relied almost exclusively on the representations of Dixon and Dimmitt.

Petitioners' realization of substantial losses from 1977 to 1983 is additional evidence that petitioners did not engage in the Nitrol Program for profit. Sec. 1.183–2(b)(6), Income Tax Regs.; *Wiles v. United States*, 312 F.2d 574, 576 (10th Cir.

Over $162,400	$215,400	.....	68 percent
Over 215,400		.....	70 percent

Consequently, petitioners' taxable income (before claiming the Nitrol loss deductions), for the years in issue, except for Dressler and Overnite, Ltd., was subject to at least a 50-percent tax rate.

1962). Petitioners argue, however, that these losses are not indicative of a lack of profit motive but are attributable to unforeseen events. Specifically, petitioners cite the severe winter of 1977–78 and the shortage of owner-operators to pull petitioners' trailers.

Although we agree with petitioners that the severe winter of 1977–78 partially contributed to the substantial losses sustained in 1977 and 1978, petitioners offered no evidence suggesting that the weather affected trailer operation in subsequent years. Moreover, we find petitioners' emphasis on their inability to locate owner-operators unpersuasive because petitioners' Nitrol trailers continued to sustain substantial losses following petitioners' 1979 purchase of tractors to pull the trailers.

Petitioners also argue that notwithstanding the history of losses, the business-like operation of the Nitrol Program and the subsequent capital contributions to TMC and Road West indicate a strong intent to make a profit. Although we agree that the Nitrol Program was operated in a business-like manner and that petitioners exhibited some commitment to the investment, this evidence, alone, is insufficient to establish the requisite profit motive. See *Carter v. Commissioner*, 645 F.2d 784, 786 (9th Cir. 1981), affg. a Memorandum Opinion of this Court; *Bolt v. Commissioner*, 50 T.C. 1007, 1013 (1968).

The Nitrol Program was marketed on the basis that each trailer would generate sufficient income to pay all operating expenses and to amortize the nonrecourse notes. TMC's business-like operation, therefore, was necessary if it intended to satisfy petitioners' creditors on a regular basis and avoid foreclosure to protect petitioners' future and previously claimed tax benefits.

Similarly, petitioners' commitment to the investment was consistent with petitioners' desire to avoid foreclosure and protect future and previously claimed tax benefits. Petitioners testified at trial that they were aware that the disposition of the trailers would result in tax consequences. The private placement memorandum relied on by petitioners described these tax consequences in detail. Consequently, since each petitioner received, on the average, tax benefits equal to approximately 200 percent of the total cash he invested in the Nitrol Program, including capital contributions to TMC and

Road West,[7] we believe petitioners agreed with Puckett's conclusion contained in his letter to petitioners dated September 9, 1978, that the potential tax consequences made it "prudent to consider making a reasonable capital advance."

Petitioners also contend that their financial status is indicative of a bonafide profit motive. We disagree. Section 1.183–2(b)(8) provides in pertinent part as follows:

> Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit * * *

Petitioners' income tax returns for 1977 through 1982 establish that petitioners earned sufficient income from sources other than the Nitrol Program to take substantial advantage of the tax benefits the investment generated. Petitioners' financial status is, therefore, under the circumstances herein, further evidence of petitioners' lack of a profit motive.

In conclusion, after a careful review of all the facts and circumstances, we hold that petitioners' Nitrol Program activities were "not engaged in for profit" within the meaning of section 183(a). Accordingly, respondent's determination is sustained.

To reflect the foregoing,

Decisions will be entered under Rule 155 in docket Nos. 22131–81, 22639–81 (Nitrol Issues), 28537–81, and 3114–83.

Decisions will be entered for the respondent in docket Nos. 13350–82 and 18891–82.

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[7]

Petitioners	*Loss claimed from Nitrol investment*	*Investment credit claimed from Nitrol investment*	*Tax savings at 50% tax rate*	*Total amount invested*
Sutton	$284,710	$27,500	$169,855.00	$86,911.83
Knowlton	271,951	27,500	163,475.50	124,375.01
Fleece	566,030	55,000	338,015.00	204,295.57
Pruitt	640,536	55,000	375,268.00	132,556.97
Babcock	293,199	27,500	174,099.50	73,043.56
Overnite, Ltd.	244,596	27,500	149,798.00	43,920.00
			1,370,511.00	665,102.94

JOHN M. ELLIOTT AND JANE D. ELLIOTT, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 29950–82, 28067–83. Filed February 14, 1985.

Petitioner acquired certain publication rights with respect to a gothic novel and, as consideration, paid $31,000 in cash, assigned $6,000 of the first proceeds of sales of the books, and assigned 60 percent of the remaining proceeds to be applied against a nonnegotiable, nonrecourse promissory note for $198,000. In the light of all of the facts, it is—

Held, that petitioner did not engage in the publication activities with respect to the book with an actual objective of making a profit and, therefore, he is not entitled to deductions for business expenses under sec. 162(a) or sec. 212(1), I.R.C. 1954, for depreciation under sec. 167(a), I.R.C. 1954, or to an investment credit under sec. 38, I.R.C. 1954, and related sections.

Held, further, the nonrecourse note was not a genuine indebtedness and, therefore, petitioner is not entitled to a deduction for interest thereon under sec. 163, I.R.C. 1954.

Marc A. Feller and *Daniel F. Ryan*, for the petitioners.
David Kuchinos, for the respondent.

FEATHERSTON, *Judge*: Respondent determined deficiencies in petitioners' Federal income taxes as follows:

Year	*Amount*
1978	$41,230
1979	21,364
1980	17,038

For 1980, respondent also determined that petitioners are liable for an addition to tax under section 6653(a)[1] in the amount of $852 but has now conceded that item. For convenience, petitioner John M. Elliott, whose activities produced the present controversy, will be referred to as petitioner.

The controlling issues for decision are as follows:

(1) Whether petitioner's activities in connection with the publication of a book entitled "The House on Wath Moor" constituted either a trade or business or the holding of property for the production of income in 1978, 1979, and 1980; the answer determines whether petitioner is entitled to

[1] All section references are to the Internal Revenue Code of 1954 as amended, unless otherwise noted.

deductions for printing-shipping costs under either section 162(a) or 212(1), deductions for depreciation under section 167(a), and an investment tax credit under section 38 and related sections; and

(2) Whether a nonrecourse promissory note given as part of the consideration for rights to the book entitled "The House on Wath Moor" was a genuine indebtedness. The answer controls petitioner's claim to an interest deduction under section 163.[2]

FINDINGS OF FACT

Petitioners John M. and Jane D. Elliott, husband and wife, were legal residents of Philadelphia, Pennsylvania, when they filed their petition. Jane Elliott is a party to this proceeding only because she and her husband filed joint Federal income tax returns for 1978, 1979, and 1980, the years in issue.

The present controversy arises from the disallowance of alleged losses produced by the following deductions and credits claimed by petitioner on Schedules C of petitioner's income tax returns for 1978, 1979, and 1980 with respect to his investment in a book entitled "The House on Wath Moor" (hereinafter Wath Moor):

	1978	*1979*	*1980*
Printing-shipping costs	$8,000	0	$1,056
Accelerated depreciation	24,778	$44,050	34,260
Additional first-year depreciation	4,000	0	0
Interest	0	0	9,648
Total deductions	36,778	44,050	44,964
Income reported	0	6,000	10,704
Loss claimed	36,778	38,050	34,260
Investment tax credit claimed	22,700	0	0

Petitioner is a senior partner and co-chairman of the litigation department of one of the major law firms in Philadelphia. His income for each of the 3 years here in

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[2] The parties have briefed other technical issues, including: (1) Whether petitioner "placed in service" in 1978 the assets with respect to which he claims deductions for depreciation and an investment credit for that year; (2) whether the nonrecourse note given as part of the consideration for the book rights acquired by petitioner may be recognized as part of his basis for depreciation and investment tax credit purposes; (3) whether an allocation of petitioner's book rights between tangible and intangible rights must be made; and (4) whether petitioner's claimed losses exceed the amount he had "at risk" under sec. 465 for 1979 and 1980. We find it unnecessary to deal with these technical issues.

dispute was sufficient to place him in the top brackets of the income tax rates. In late 1978, petitioner consulted with Thomas E. Doran (Doran), a member of petitioner's law firm, concerning steps he might take to minimize his tax liability. Through Doran, petitioner learned in mid-December 1978 of the possibility of investing in Wath Moor, a gothic novel written by an English author.

By letter dated December 7, 1978, Jonathan T. Bromwell & Associates, Inc. (Bromwell), had notified Jules R. Whitman, a partner in petitioner's law firm, of investment opportunities in the book area. The letter states the following:

> Thank you for requesting the formal offering documents describing our high-quality investments/tax shelters in the publishing industry. We are certain that after you have had an opportunity to review the many impressive aspects of this investment, that you will find it ideal for inclusion in your portfolio; the anticipated profits and tax savings are substantial, while the risks are minimal. Briefly highlighting several of the outstanding features of this program, please note:
>
> 1. *4½ to 1 Leverage* - 1978 deductions and tax credits total approximately *4½ to 1* for each dollar invested. The aggregate deductions and credits for 1978 and 1979, the years in which the investment is paid, are approximately 4 to 1.
>
> * * * * * * *
>
> 5. *Conservative Evaluations* - Each paperback has been conservatively valued based upon our appraisers [sic] and in light of current prices for properties of this quality * * *
>
> 6. *Tax Audit Defense Fund* - We have retained a highly-acclaimed tax attorney to provide a "test case" defense of our tax positions (if they are ever challenged).

Prior to making the offering, Bromwell and entities with which it had dealt had entered into a series of agreements as follows:

1. *Agreement with author.*—By agreement dated December 14, 1978, Maureen Stephenson (Stephenson), author of Wath Moor, sold to Kensington Publishing Corp. (Kensington) the sole and exclusive right and license to manufacture, print, publish, and distribute Wath Moor in the English language exclusively in Canada, the Philippines, and the United States and its territories, and nonexclusively in the rest of the world, except in the British Commonwealth of Nations. The agreement obligated Kensington to publish 10,000 copies by Febru-

ary 1, 1981. As consideration for the agreement, Stephenson was to be paid royalties of 6 percent of the net retail sales of the first 150,000 copies and 8 percent of the net retail sales of all copies in excess of 150,000.

This agreement was the product of negotiations conducted by Roberta Grossman, president of Kensington, in October 1978. Kensington's business after 1977 involved exclusively the mass marketing of paperback books, including, during the period 1978–79, 8 to 12 gothic novels annually. Kensington owns and uses the imprint or trade name "Zebra Books" on the covers of the books that it markets. During 1978 and 1979, Kensington's Zebra Books had net sales of $2 to $2.5 million but had less than 1 percent of the mass-market paperback industry. In 1978, about a dozen other publishers had 90 to 95 percent of the paperback book market.

2. *Acquisition agreement.*—By contract dated October 20, 1978, Kensington sold its rights, title, privileges, interest, and ownership in the book properties pertaining to Wath Moor, together with the right to print, publish, distribute, and sell Wath Moor in paperback form to Bromwell, one of its subsidiaries. The agreement specifically excluded radio and television rights from the transfer. As consideration for the transfer, Bromwell agreed to pay Kensington $4,000 in cash (downpayment of $1,000 plus $3,000 by the end of 1978) and to execute and deliver a nonnegotiable, nonrecourse promissory note due on October 1, 1987, in the amount of $198,000 bearing interest at the rate of 6 percent per annum. The interest and principal of the note were to be paid semiannually from 60 percent of the net dollars derived and actually received from sales after returns and after a reasonable reserve for returns of books. The only security for the note in the event of default was forfeiture of the rights to the property transferred. Bromwell executed the note under date of October 20, 1978.

In connection with the making and giving of the $198,000 nonnegotiable promissory note by Bromwell to Kensington, Bromwell and Kensington entered into a security agreement, dated October 20, 1978, whereby Bromwell, as debtor, conveyed to Kensington, as the secured party, all of Bromwell's right, title, and interest in and to the book properties pertinent to Wath Moor to secure the payment of the note.

3. *Services agreement.*—By agreement dated October 20, 1978, Bromwell entered into a services agreement with Hercules Service Corp. (Hercules), another subsidiary of Kensington, with regard to certain services to be performed with respect to Wath Moor. Hercules was newly formed to promote Wath Moor and some other books that Kensington was selling to Bromwell.

Under the terms of the agreement, Hercules agreed to produce, print, bind, distribute, sell, and promote the book for a period of 9 years. The agreement stated that Hercules was to print, bind, and have distributed for retail sale to the public no less than 35,000 copies of Wath Moor prior to the end of 1978. Hercules further agreed to publish a second printing of Wath Moor in a number equal to at least 75 percent of the number of copies sold during the 3 years prior to the publication of the second printing; however, if Hercules printed a number of copies equal to at least 50 percent of the initial guaranteed printing of 35,000 copies, then the obligation of Hercules would be satisfied.

Under the services agreement, Hercules was to receive $8,000 from Bromwell for the first 9,768 books sold and 32 cents each for the next 28,732 books sold. After 35,000 books were sold, Hercules was to receive 13.3 cents for each book sold. Hercules warranted in the agreement that Bromwell would receive at least $6,000 out of the first receipts by Hercules from the sale of the books, payable not later than 16 months after the date of the initial publication.

A schedule attached to the services agreement states that the anticipated cover price for Wath Moor was $1.95 and that the "number of copies required to be sold to recoup costs" was 367,647. Of all the gothic novels that Kensington has published under the Zebra imprint, none has achieved a printing of as many as 100,000 copies.

4. *Review and investigation by petitioner.*—Copies of all of these agreements together with a 72-page "Confidential Memorandum" (offering memorandum) were made available to petitioner for review. In addition, exhibits attached to the offering memorandum included: (1) A commitment agreement to be signed by Bromwell and a purchaser of a book, (2) a list of the titles of 53 books, including Wath Moor, available for purchase; (3) a legal opinion by the law firm of Weiss,

Rosenthal, Heller & Schwartzman on the tax consequences to the purchaser of one of the books; and (4) a one-paragraph synopsis of each of the 53 books offered for sale, together with a brief biographical sketch of the author and financial data. As to Wath Moor, the financial data was as follows:

Cash cost to be paid over 2 years

At closing	$17,000
Feb. 15, 1979	14,000
Total cash cost	31,000
Guaranteed income to be applied to payment	6,000
Nonrecourse note	198,000
Total cost	235,000

Guaranteed income: $6,000
Initial printing: 80,000 copies

On 39 of the books described in the offering memorandum, the financial data was the same as that set forth above; another set of financial data was shown for the other 14 books. Among the other attachments to the offering memorandum was a statement of other financial data in tabular form including an anticipated cover price of $1.95 for Wath Moor and a statement that 367,647 copies would have to be sold to pay the principal of the nonrecourse note.

Among the materials that petitioner received from Bromwell was the following statement illustrating the investment and tax aspects of owning one of Bromwell's books:

CLASS A INVESTMENT

Total cash investment paid over 2 years	$31,000
Minimum guaranteed income applied to purchase price	6,000
Nonrecourse promissory note	198,000
Total price	235,000

	1978	*1979*
Payment on closing	$17,000	0
Payment due Feb. 15, 1979	0	$14,000
Total cash investment	17,000	14,000

TAX BENEFITS AND INCOME

Net tax deductions	42,000	37,000
Investment tax credit	22,700	0

Guaranteed cash flow (to be applied to purchase price)	0	$ 6,000
Cumulative tax savings and cash flow:		
For 50% income tax bracket	$43,700	68,200
For 70% income tax bracket	52,100	84,000

Prior to his investment in Wath Moor, petitioner had never purchased or otherwise invested in any venture involving the production, distribution, or exploitation of books. Apart from the offering memorandum materials, he knew nothing about the author of Wath Moor or the book itself. He reviewed the offering memorandum and related materials but did not seek any independent advice on the value of Wath Moor, or the economic feasibility of publishing it, before making his investment.

The offering memorandum states that the seller had obtained opinion letters from two individuals, experienced in the industry, which "may serve as some evidence of the reasonableness of the selling price of the Properties." (The contents of these letters are described in the opinion portion which follows.) One of the letters is dated December 20, 1978, and the other is dated December 27, 1978. Petitioner did not obtain the opinion of an expert of his own choosing on the economic feasibility of the offered investment.

Prior to petitioner's investment, petitioner engaged in no negotiations regarding the terms of the purchase of Wath Moor. The purchase price was set forth in the offering memorandum, was dictated by Bromwell, and was inflexible. Petitioner made no effort to get the purchase price reduced.

5. *Purchase and assumption agreement.*—By agreement dated December 26, 1978, Bromwell sold to petitioner all of Bromwell's right, title, interest, and ownership in Wath Moor, and all of Bromwell's rights and interest in and under the acquisition agreement described above. Under the same date, Bromwell assigned to petitioner the services agreement made between Bromwell and Hercules.

By letter of the same date, petitioner instructed Hercules to pay to Bromwell the first $6,000 received from such sales in accordance with the agreement. Petitioner also instructed Hercules to pay directly to Kensington 60 percent of the gross receipts from the sales of copies of Wath Moor in excess of the

first $6,000 of such proceeds until the $198,000 nonrecourse note plus interest had been paid.

By letter dated December 26, 1978, petitioner advised Kensington that he had purchased from Bromwell all of the properties acquired by Bromwell from Kensington relating to Wath Moor, as well as all related covenants and agreements, and had assumed all of Bromwell's obligations under the $198,000 nonnegotiable promissory note.

By letter dated December 26, 1978, Roberta Grossman, president of Kensington, advised petitioner that Kensington would look only to Hercules for payment of the 60 percent of gross receipts payable under the nonnegotiable promissory note.

In connection with the December 26, 1978, purchase and assumption agreement, petitioner paid Bromwell $17,000 by check of that date. By check dated February 13, 1979, petitioner made another payment to Bromwell in the amount of $14,000 as provided by the agreement.

It is the general practice of Kensington and Hercules to solicit orders for books 3 or 4 months before the book is ready for retail sale. The promotional covers for Wath Moor were printed and made available in late December 1978 to Kable News Co. (Kable), a national distributor, for the purpose of soliciting orders for the book. The covers for the sale copies were printed on March 1 and 2, 1979.

Wath Moor was printed by Offset Paperback Manufacturers, Inc., of Dallas, Pennsylvania. A total of 30,502 copies were printed based on the number of orders that had been obtained. The first printing was finished on March 10, 1979, and shipments were completed on March 15, 1979.

As of June 30, 1982, 30,502 copies of Wath Moor had been distributed; 13,265 copies had been sold; 15,743 copies had been returned unsold, and 125 copies were still available for sale. As of June 30, 1982, total gross receipts from the sale of Wath Moor were $10,864. Of that amount, $7,119.04 had been paid to Hercules under the services agreement, $2,918.40 had been paid to Kensington as interest on the nonnegotiable promissory note, $825.28 had been paid to petitioner, and $1.28 was due to petitioner.

Petitioner did not get involved in any way in the day-to-day decision making with respect to the promotion and exploita-

tion of Wath Moor. He was not aware of the type of advertising campaign, if any, that the services contractor undertook in connection with the promotion of the book. He did not know how many books had been printed or sold. Petitioner kept no books of account with respect to Wath Moor.

In 1982, Wath Moor was reprinted with a new cover but the same text under the title "House on the Heath." The decision to market Wath Moor under a new title was made by Kensington without consulting petitioner.

In the notices of deficiency, respondent disallowed the Schedule C losses claimed on petitioner's income tax returns for 1978, 1979, and 1980.

ULTIMATE FINDINGS OF FACT

(1) Petitioner's activities in connection with Wath Moor were not undertaken or carried out with an actual and honest objective of making a profit.

(2) The amount of the nonnegotiable, nonrecourse note in the amount of $198,000 unreasonably exceeded the value of Wath Moor and was not a genuine indebtedness.

OPINION

Petitioner's claim to the disallowed deductions for the Wath Moor printing-shipping costs for 1978 and 1980 depends on a showing that these amounts were ordinary and necessary expenses paid or incurred during the taxable year in carrying on a "trade or business" within the meaning of section 162(a), or ordinary and necessary expenses paid or incurred during the taxable year "for the production * * * of income" within the meaning of section 212(1). To qualify the claimed depreciation deductions, petitioner must show, among other things, that the property was used in his "trade or business" or was held "for the production * * * of income" within the meaning of section 167(a). The investment credit is allowable, according to section 48(a)(1), only for "property with respect to which depreciation (or amortization in lieu of depreciation) is allowable."

Thus, petitioner's right to the printing-shipping and depreciation deductions as well as to the investment credit depends on petitioner's showing that his Wath Moor activity constituted a

trade or business or was undertaken and carried on for the production of income. See *Flowers v. Commissioner*, 80 T.C. 914, 931 (1983); *Pike v. Commissioner*, 78 T.C. 822, 841–842 (1982), affd. without published opinion 732 F.2d 164 (9th Cir. 1984).

Petitioner's right to the claimed section 163 interest deduction depends upon a showing that the nonrecourse note was a genuine indebtedness. See *Odend'hal v. Commissioner*, 80 T.C. 588, 604–605 (1983), affd. 748 F.2d 908 (4th Cir. 1984), and cases cited.

1. Printing-Shipping Cost, Depreciation, and Investment Credit

Essential to petitioner's showing that his activities with respect to Wath Moor constituted a trade or business or that Wath Moor was held for the production of income is a demonstration of an "actual and honest objective of making a profit." *Dreicer v. Commissioner*, 78 T.C. 642, 646 (1982), affd. without published opinion 702 F.2d 1205 (D.C. Cir. 1983); *Fuchs v. Commissioner*, 83 T.C. 79, 98 (1984); *Dean v. Commissioner*, 83 T.C. 56, 74 (1984). While a reasonable expectation of profit is not required, petitioner's objective of making a profit must be bona fide. *Fox v. Commissioner*, 80 T.C. 972, 1006 (1983), affd. without published opinion 742 F.2d 1441 (2d Cir. 1984), affd. sub nom. *Barnard v. Commissioner*, 731 F.2d 230 (4th Cir. 1984), affd. without published opinion sub nom. *Kratsa v. Commissioner*, 734 F.2d 6 (3d Cir. 1984), affd. without published opinion sub nom. *Hook v. Commissioner*, 734 F.2d 5 (3d Cir. 1984).

The issue as to whether a transaction is undertaken with a profit objective is one of fact to be resolved not on the basis of one factor alone but on the basis of all the facts and circumstances. *Allen v. Commissioner*, 72 T.C. 28, 34 (1979); *Jasionowski v. Commissioner*, 66 T.C. 312, 319, 321 (1976). Some of the relevant factors to be considered in determining whether an activity is engaged in for profit are listed in section 1.183–2(b), Income Tax Regs.[3] In deciding the issue as to

[3] Sec. 1.183–2. Activity not engaged in for profit defined.

(b) *Relevant factors.* In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account. No one factor is

whether petitioner's Wath Moor activity was engaged in for profit, greater weight is to be given to objective facts than to a mere statement of a taxpayer's intent. *Siegel v. Commissioner*, 78 T.C. 659, 696–698 (1982); *Engdahl v. Commissioner*, 72 T.C. 659, 666 (1979).

Based on all of the evidence of record, we find that petitioner did not engage in the Wath Moor activity with an actual and honest objective of making a profit and that, consequently, such activity was not a trade or business or an undertaking for the production of income. Rather, we are convinced that petitioner engaged in the Wath Moor transaction primarily, if not exclusively, in order to obtain tax deductions and credits and thereby reduce the tax he would otherwise have to pay on his substantial income from other sources. Petitioner is not, therefore, entitled to the claimed printing-shipping and depreciation deductions or the disputed investment credit.

We begin with the fact that petitioner's first step toward the Wath Moor deal was his consultation in late 1978 with Doran, a member of his law firm. The clear inference is that he wished to minimize his income taxes. The literature on the Wath Moor offering showed that it certainly promised to fulfill that objective. For his $17,000 investment in 1978, according to the statement from Bromwell, quoted in our findings, which illustrated the tax aspects of the investment, petitioner would receive tax savings ranging from $43,700 (50-percent bracket) to $52,100 (70-percent bracket) in that year alone. For another $14,000 in 1979, his cumulative tax savings and cash flow would rise to amounts ranging from $68,200 (50-percent bracket) to $84,000 (70-percent bracket). "Where, as here, the promised tax benefits are suspiciously excessive and," as we

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determinative in making this determination. In addition, it is not intended that only the factors described in this paragraph are to be taken into account in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. Among the factors which should normally be taken into account are the following:

(1) *Manner in which the taxpayer carries on the activity.* • • •
(2) *The expertise of the taxpayer or his advisors.* • • •
(3) *The time and effort expended by the taxpayer in carrying on the activity.* • • •
(4) *Expectation that assets used in activity may appreciate in value.* • • •
(5) *The success of the taxpayer in carrying on other similar or dissimilar activities.* • • •
(6) *The taxpayer's history of income or losses with respect to the activity.* • • •
(7) *The amount of occasional profits, if any, which are earned.* • • •
(8) *The financial status of the taxpayer.* • • •
(9) *Elements of personal pleasure or recreation.* • • •

shall discuss, "the transaction as a whole is entered into and carried out with a complete indifference to profit, it is clear what the parties intended to accomplish." *Flowers v. Commissioner*, 80 T.C. at 941. We are convinced that the primary, if not the only, objective petitioner sought to accomplish was the reduction of his taxes.[4]

These suspiciously high tax benefits were made possible by the use of the $198,000 nonrecourse note as part of the claimed basis for depreciation and investment tax credit purposes. The use of large nonrecourse financing compared with a small cash investment is not necessarily fatal to establishing a profit objective, but we think it is a strong factor working against petitioner in this case because there was no practical probability that the note would be paid. *Barnard v. Commissioner*, 731 F.2d 230, 231 (4th Cir. 1984), affg. *Fox v. Commissioner*, 80 T.C. 972 (1983); *Estate of Baron v. Commissioner*, 83 T.C. 542, 556 (1984). To pay the full amount of the note, according to the offering memorandum and Bromwell's "expert" reports, would have required sales of approximately 370,000 copies of Wath Moor. As indicated in our findings, Kensington had never printed, let alone sold, as many as 100,000 copies of any gothic novel, and Wath Moor had nothing outstanding to recommend it. Informed experts were of the opinion that a maximum of 30,000 copies would be sold. In fact, net sales came to only 13,265 as of June 30, 1982.

Notwithstanding the bleak prospects for profit from the deal, petitioner did nothing to attempt to negotiate a smaller purchase price. He simply accepted Bromwell's offer on terms which the parties have stipulated were "inflexible." The record is devoid of any evidence showing that the purchase

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[4] The following statement in *Barnard v. Commissioner*, 731 F.2d 230, 231 (4th Cir. 1984), affg. *Fox v. Commissioner*, 80 T.C. 972 (1983), is apposite:

"Summarily, the tax-minimizing scheme, an evasion not a mere avoidance of tax liability, was structured so that, if not a single copy of the book were ever marketed, nevertheless, the 'deductions' generated for income tax purposes would, for high bracket taxpayers * * *, be so great that they would, if the fabricated "deductions" were allowed, reduce taxes by a substantially greater amount than the relatively small sums contributed in cash * * * by each taxpayer."

Notwithstanding the above illustrations of tax savings offered by the Wath Moor plan, petitioner's testimony alludes to potential unidentified tax recapture liabilities. We are not convinced (and he does not argue on brief), however, that the tax recapture provisions were seriously considered; even if they were, the Wath Moor scheme contemplated, as a minimum benefit, the extended deferral of any tax liabilities subject to recapture. *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985), affg. in part and revg. in part 81 T.C. 184 (1983).

price for Wath Moor was in any way determined with a "true regard for the profitability of the activity." *Brannen v. Commissioner*, 78 T.C. 471, 509 (1982), affd. 722 F.2d 695 (11th Cir. 1984); *Fox v. Commissioner*, 80 T.C. at 1010. In fact, from petitioner's standpoint, there was no incentive to negotiate for a lower nonrecourse liability because a lower amount would have only reduced his basis for depreciation and investment credit purposes and, concomitantly, his tax benefits. Cf. *Fox v. Commissioner*, *supra* at 1009.

Furthermore, petitioner did not even investigate the economic feasibility of the Wath Moor proposal, and failure to make such an investigation tends to show the absence of a "business-like manner of operation." Sec. 1.183–2(b)(1), Income Tax Regs. *Surloff v. Commissioner*, 81 T.C. 210, 237 (1983); *Fox v. Commissioner*, 80 T.C. at 1015. Petitioner had no experience in publishing and selling books. In Bromwell's offering memorandum, he was warned that: "Only a small percentage of all books published whether hard cover and/or soft cover generate a profit to their publishers." The memorandum adds, in substance, that sales of the offered book publication rights will be made only to persons with a net worth of at least $200,000 and some portions of whose income would be subject to tax at a rate of 48 percent (with respect to corporations) and 50 percent (with respect to individuals).

Given these and other similar warnings in the offering memorandum, a reasonably prudent profit-motivated investor who had no previous book publishing experience, proceeding in a business-like manner, would be expected to obtain some expert guidance. In fact, the offering memorandum states that "Each Purchaser who lacks experience in the publishing industry is advised to retain a consultant to assist him in connection with the commercial exploitation of any Properties he acquires." Petitioner did not do so. He sought no outside information on the hazards or prospects of publishing-venture investments. Nor did he seek any independent advice with regard to the value of Wath Moor or its sales potential. He knew nothing, and sought to learn nothing, about its author or the salability of her writings beyond the brief biographical sketch in an attachment to the offering memorandum.

The offering memorandum stated that Bromwell had caused the several books it was offering for sale to be reviewed by two

individuals experienced in the publishing business and that their written opinions were available for inspection. One of these "appraisals" is dated December 20, 1978, and states:

> 9. The purchase price of the above book is $227,000. In order to reach this figure, to the best of my knowledge, approximately 370,000 copies of the literary work noted must be sold.
>
> 10. I project that the revenues from the proper exploitation of this book may, at least, meet the purchase price. Indeed, after deduction of all costs under the service agreement, they may exceed it.

The other appraisal, dated December 27, 1978, 1 day after petitioner made his purchase, reaches almost exactly the same conclusions in 12 similarly numbered and ordered paragraphs but in different words which appear to have been carefully chosen because of their difference.

Petitioner testified that one of the things he relied on in the offering memorandum was the representation that he would receive two letters concerning the fair market value of the book. Petitioner further testified that "I assure you if there were ever misrepresentations that were made to me in any way, I will pursue those representations through the litigation resources that I have at my disposal."

We seriously doubt that petitioner, an accomplished trial lawyer, proceeding in a businesslike manner in handling a case of the magnitude of this transaction, would allow his adversary (in this case, Bromwell, the seller) to select his expert witnesses. Nor do we think he would find very convincing the tentative opinions that Bromwell's alleged experts expressed in those strikingly similar "appraisals." Significantly, neither of the individuals who made the appraisals was called to testify at the trial of the instant case.

Had petitioner consulted experts of the caliber of two witnesses called by respondent, Stephen Conland (Conland) and Robert Sachs (Sachs), both of whom had years of experience in the publishing business, he would have learned that the Wath Moor rights acquired by petitioner had a value of between $0 (according to Conland) and approximately $7,800 (according to Sachs). He would have learned that there was no practicable probability that he would make a profit or that he would even recover his $31,000 cash investment. As of December 26, 1978, a reasonable estimate of net sales was 26,250 copies (according to Conland) and 30,000 (according to Sachs).

These estimated sales are to be contrasted with the sales of approximately 370,000 required, according to the offering memorandum and the Bromwell-furnished experts, to pay the nonrecourse note. He would have learned also that Kensington, as stated above, had never printed, let alone sold, as many as 100,000 copies of a gothic novel and that, in the judgment of experts, there was nothing unique about Wath Moor or its author, who was virtually unknown, to suggest that any unusually large number of copies of Wath Moor would be sold.

Apart from these estimates, petitioner would have also learned that Kensington did not have a strong position among competing publishers in 1978, and this relatively weak position would make it even less likely that Wath Moor would succeed. About a dozen other publishers had 90 to 95 percent of the mass paperback book market. Kensington's Zebra Books commanded less than 1 percent of the market. The shelf life of a paperback book is only a few weeks, and the larger publishers can take advantage of these few weeks much more effectively than can a smaller publisher like Kensington.

By consulting experts, petitioner would have also learned that the Bromwell-Hercules-Kensington agreements, reviewed in our findings, were structured in such way as practically to preclude sales of enough copies of Wath Moor to make a profit. Putting a quantity of paperback books on the market in 1978 cost approximately 45 cents per copy. By assuming Bromwell's services agreement with Hercules, petitioner became obligated to pay Hercules 82 cents for each of the first 9,768 copies of Wath Moor, 32 cents for each of the next 28,732 copies, and 13.3 cents for each additional copy thereafter. Thus, Hercules would suffer substantial losses on the printing of copies of Wath Moor in excess of 38,500 copies; the losses would amount to approximately $100,000 for printing the 330,000 copies (above the 38,500 copies) required to pay the nonrecourse note. Hercules, which would suffer this loss, was a subsidiary of Kensington, and Kensington controlled the marketing of Wath Moor. Experts would have advised petitioner that Kensington would hardly be expected to handle the sales program in such a way as to cause Hercules to incur such a huge loss. We think a conscientious, qualified expert would have advised petitioner that any prospect of the printing and sale of enough copies to permit him to recover even his cash outlay was illusory.

True, petitioner called as an expert witness an individual who testified that Wath Moor had a value of $198,000 based on a sale of 250,000 copies at $1.95 per copy and a value of $267,176.26 based on a sale of 250,000 copies at $2.50 per copy. The testimony of this witness, who had only limited experience in reviewing paperback book manuscripts, was not credible, however. He was unable to state the date as of which his value and sales estimates were made. He failed to adjust his value estimates for royalties payable to the author, and her royalties on the sales of 250,000 copies would be in the range of $33,000. In fact, on cross-examination, he admitted that arriving at a fair market value appraisal is "not generally in the area of the thing that I do."

Petitioner's witness testified that he based his 250,000 estimated sales figure for Wath Moor on the ability of the chairman of Kensington's board to market his product. But the witness admitted that he did not know what Kensington's share of the paperback book market was in 1978 or that Kensington had never printed, let alone sold, as many as 100,000 copies of any single gothic novel. As to the suggested $2.50 sales price, both the offering memorandum and the services agreement state that the anticipated sales price of Wath Moor was $1.95 per copy. Not until the book was reprinted under the title "House on the Heath" in 1982 was the $2.50 price used. The testimony of petitioner's witness, in our opinion, is not worthy of any weight in deciding the issues here presented. See *Flowers v. Commissioner*, 80 T.C. at 940–941 n. 40.

After petitioner acquired Wath Moor, he did not participate in any way in decisions with respect to the management of the business; he left everything to Hercules and Kensington. In his words: "I relied totally upon what they did." Even though it must have been apparent to him within a few months that the business was not working out as he now says he expected, he did not inquire as to when the printing was completed nor as to what publicity or other promotional activities were undertaken. He never asked for information to enable him to ascertain whether Hercules and Kensington were carrying out their contractual responsibilities efficiently or conscientiously. Indeed, he was not even contacted at all with respect to the

reprinting and distribution of the book under the name "House on the Heath."

In summary, we find that petitioner has not carried his burden of proving that he had an actual and honest objective of making a profit from publishing Wath Moor. He entered the deal near the end of 1978 only after seeking advice from a tax attorney on how he could minimize his taxes. The transaction as presented to him showed that it was highly leveraged. Although he had no expertise in the publishing business, he made no real investigation of the proposal. After he became aware that the business was not succeeding, he devoted no time to attempt to rectify the situation. He neither entered the deal nor handled his investment in a businesslike manner. We conclude that petitioner's Wath Moor activities were not undertaken or carried out with an actual and honest objective of making a profit and that they were not, therefore, a trade or business. Petitioner is not entitled to the disallowed printing-shipping and depreciation deductions or the investment tax credit.

Petitioner's position, if we understand it, is that respondent's argument "ignores the realities of the business world." He contends that he handled his Wath Moor investment in the same manner as numerous others he has made. He reviewed the offering memorandum, decided Wath Moor would be a good investment, advanced the $17,000 in December 1978 and the $14,000 in February 1979, and left everything else to the publishing experts, Kensington and Hercules. He was too busy in the practice of law, he argues, to attempt to exercise business judgments in the publishing world. He maintains that he believed "that it was reasonable for him to rely on the expertise of Kensington and Hercules and felt that they were more qualified than he was to make business decisions regarding the profitable exploitation of Wath Moor."

Petitioner's arguments have a hollow ring. They would be more pertinent if petitioner were seeking to justify a loss from a passive capital investment. This case, however, does not involve a passive capital investment; it involves an alleged trade or business. Petitioner is here seeking to justify losses attributable to trade or business deductions under section 162(a) or "for the production of income" under section 212(1), and depreciation deductions and an investment credit which

are allowable only if he used the Wath Moor book properties in a trade or business or held the Wath Moor properties for the production of income as required by section 167(a). Essential to a trade or business or an income-producing activity that will support the tax benefits claimed by petitioner is an actual and honest objective of making a profit. *Hirsch v. Commissioner*, 315 F.2d 731, 736 (9th Cir. 1963), affg. a Memorandum Opinion of this Court; *United States v. Gilmore*, 372 U.S. 39, 48 (1963). Petitioner had no such objective. The facts make it almost inconceivable that petitioner would have entered the Wath Moor deal as a passive capital investment financed mainly by an excessive nonrecourse note without any claim to depreciation deductions and an investment credit. Thus, petitioner's arguments in this regard are inapposite.

We think it apparent that petitioner's objective was not to make a business profit, but rather to reap the tax benefits provided by the highly leveraged Wath Moor deal. This case is indistinguishable in principle from *Fox v. Commissioner*, 80 T.C. 972 (1983), affd. without published opinion 742 F.2d 1441 (2d Cir. 1984), affd. sub nom. *Barnard v. Commissioner*, 731 F.2d 230 (4th Cir. 1984), affd. without published opinions sub nom. *Hook v. Commissioner*, *Kratsa v. Commissioner*, *Leffel v. Commissioner*, *Rosenblatt v. Commissioner*, *Zemel v. Commissioner*, 734 F.2d 5–7, 9 (3d Cir. 1984); *Dean v. Commissioner*, 83 T.C. 56 (1984); *Fuchs v. Commissioner*, 83 T.C. 79, 98 (1984); *Ziegler v. Commissioner*, T.C. Memo. 1984–620.

2. *The Interest Deduction*

Section 163(a) provides for the allowance of a deduction for "all interest paid or accrued within the taxable year on indebtedness." For the deduction to be allowable, however, the indebtedness must be genuine because nonrecourse loans offer obvious opportunities for trifling with reality. In *Hager v. Commissioner*, 76 T.C. 759, 773–774 (1981), the Court stated:

> It is settled that amounts paid as interest must be paid on genuine indebtedness to be deductible under section 163(a) (*Knetsch v. United States*, 364 U.S. 361 (1960); *Narver v. Commissioner*, 75 T.C. 53, 98 (1980), on appeal (9th Cir., Jan. 15, 1981); *Golsen v. Commissioner*, 54 T.C. 742, 754 (1970), affd. 445 F.2d 985 (10th Cir. 1971) * * *. In the usual sale of property, if part or all of the purchase price is deferred, the obligation to pay the deferred amount represents genuine indebtedness and an investment in property. Even if

such an obligation is secured only by the transferred property or other property and the buyer has no personal liability for its payment, the obligation still represents genuine indebtedness and an investment in property. *Mayerson v. Commissioner*, *supra* at 351–352; see *Crane v. Commissioner*, 331 U.S. 1 (1946). However, such conclusions do not follow when the principal amount of such nonrecourse indebtedness unreasonably exceeds the value of the security therefor because, under such circumstances, it is patent that the purchaser has no incentive to pay off the obligation.

If the purchase price and the principal amount of the nonrecourse note unreasonably exceed the value of the property to be purchased, then no "genuine indebtedness exists."[5] *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976), affg. 64 T.C. 752 (1975); *Hager v. Commissioner*, 76 T.C. 759 (1981); *Odend'hal v. Commissioner*, 80 T.C. 588, 604–605 (1983), affd. on this issue 748 F.2d 908 (4th Cir. 1984). In *Estate of Franklin v. Commissioner*, 544 F.2d at 1048–1049, the court explained the rationale as follows:

> An acquisition such as that of Associates if at a price approximately equal to the fair market value of the property under ordinary circumstances would rather quickly yield an equity in the property which the purchaser could not prudently abandon. This is the stuff of substance. It meshes with the form of the transaction and constitutes a sale.
>
> No such meshing occurs when the purchase price exceeds a demonstrably reasonable estimate of the fair market value. Payments on the principal of the purchase price yield no equity so long as the unpaid balance of the purchase price exceeds the then existing fair market value. Under these circumstances the purchaser by abandoning the transaction can lose no more than a mere chance to acquire an equity in the future should the value of the acquired property increase. While this chance undoubtedly influenced the Tax Court's determination that the transaction before us constitutes an option, we need only point out that its existence fails to supply the substance necessary to justify treating the transaction as a sale *ab initio*. It is not necessary to the disposition of this case to decide the tax consequences of a transaction such as that before us if in a subsequent year the fair market value of the property increases to an extent that permits the purchaser to acquire an equity. [Fn. ref. omitted.]

The court also said (544 F.2d at 1049):

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[5] In *Brannen v. Commissioner*, 78 T.C. 471, 493 (1982), affd. 722 F.2d 695 (11th Cir. 1984), this Court stated that the test was whether the stated purchase price unreasonably exceeded the value of the property, whereas in *Hager v. Commissioner*, 76 T.C. 759, 774–775 (1981), this Court stated that the test was whether the principal amount of the nonrecourse indebtedness unreasonably exceeded the value of the property. We need not decide that issue here because both the purchase price and the principal amount of the nonrecourse note far exceeded the value of the rights to Wath Moor.

To justify the deduction the debt must exist; potential existence will not do. For debt to exist, the purchaser, in the absence of personal liability, must confront a situation in which it is presently reasonable from an economic point of view for him to make a capital investment in the amount of the unpaid purchase price. * * *

In our discussion of issue 1, we have concluded that the nonrecourse note in this case was not given in connection with a bona fide profit-seeking activity. In reaching this conclusion, we reviewed the expert testimony which shows that there was no realistic possibility that the nonrecourse note would be paid. Compared with a total purported "consideration" of $235,000, the Wath Moor book properties had a fair market value of $0 to $7,800. Compared with sales of almost 370,000 copies required to recoup all costs, including the nonrecourse note, a reasonable estimate of actual potential sales was 26,250 to 30,000 copies. We pointed out that Kensington had never printed, let alone sold, as many as 100,000 copies of a gothic novel. And petitioner's own expert witness estimated potential sales at 250,000 copies.[6]

We conclude that the $198,000 nonrecourse note was not genuine indebtedness. The note was not given in connection with a good-faith profit-seeking activity. Its amount far exceeded the value of Wath Moor. There was no realistic prospect that it would be paid. The claimed interest deduction in 1980 is not, therefore, allowable.[7]

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[6] In *Milbrew v. Commissioner*, 710 F.2d 1302 (7th Cir. 1983), affg. a Memorandum Opinion of this Court, property bought in mid-1967 for $525,000 was purportedly sold in early 1969 for a note of $3 million. Holding that the note was not genuine indebtedness, the court said (p. 1307):

"It cannot carry the day for * * * [the taxpayer] merely to show that the plant was worth *between* what Northland had paid in 1967, $525,000, and what NVST purported to pay Northland in 1969, $3 million."

[7] We have found it unnecessary to deal with respondent's arguments that, because the nonnegotiable note was not genuine indebtedness, it may not be taken into account in computing petitioner's basis for depreciation purposes under sec. 167, his actual investment for sec. 38 investment tax credit purposes, or the amount of his investment at risk (for 1979 and 1980) for purposes of sec. 465. Nonetheless, we observe that the reasoning of the cases cited in the text on this issue supports respondent's argument. See particularly *Hager v. Commissioner*, 76 T.C. 759, 773–774 (1981); *Odend'hal v. Commissioner*, 80 T.C. 588, 604–605 (1983), affd. on this issue 748 F.2d 908 (4th Cir. 1984), and cases cited.

Petitioner argues that *Commissioner v. Tufts*, 461 U.S. 300 (1983), requires the nonrecourse note recognized, but see *Odend'hal v. Commissioner*, *supra*; *Dean v. Commissioner*, 83 T.C. 56, 78 n. 10 (1984); *Fuchs v. Commissioner*, 83 T.C. 79, 102 n. 10 (1984), rejecting this argument.

3. *Allocation of Allowed Deductions*

In the notices of deficiency for 1979 and 1980, respondent disallowed only the claimed losses of $38,050 and $34,060, respectively. The effect of this treatment was to allow deductions equal to the amounts of income reported from the Wath Moor activity, $6,000 in 1979 and $10,704 in 1980 in accordance with section 183(b).[8]

In *Odend'hal v. Commissioner*, 748 F.2d at 908, the Court of Appeals affirmed this Court's opinion but remanded the case to this Court for an allocation of the allowed amounts among the claimed deductions because such an allocation "affects the taxpayers' basis for a future transfer and possibly also the yearly computation of depreciation if anything other than a straight-line method is authorized and employed." For 1978, no income was reported and no deductions are, therefore, allowable. For 1979, the only deduction claimed by petitioner was accelerated depreciation, and the full amount of the allowable amount is allocable to that deduction. As to 1980, the reported income of $10,704 exactly equals the claimed deductions for printing-shipping ($1,056) plus interest ($9,648); if an *Odend'hal* allocation is required with respect to these deductions, we think it would be appropriate to allocate the allowable amounts to those items because the income was evidently applied mainly to them.

In conclusion, we note that this is now the fifth case to have come before us involving taxpayers who have invested in book properties, not for any true business purpose, but for the purpose of generating artificially high tax deductions through nonrecourse debt which bears no relationship to the actual fair market value of the book properties purchased. In each of these five cases, we have concluded that the taxpayers had no honest profit objective in engaging in the activity, and that the nonrecourse debt involved was not a genuine indebtedness.

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[8] SEC. 183. ACTIVITIES NOT ENGAGED IN FOR PROFIT.

(b) DEDUCTIONS ALLOWABLE.—In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed—

(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

Thus, we have denied the claimed deductions and credits generated by the book investments. Three Courts of Appeals reviewed this Court's decisions in the *Fox* cases and affirmed them.

This case was well tried and skillfully briefed by able counsel, but neither the evidence nor the briefs present anything new. At some point, the arguments in these highly leveraged tax avoidance (or evasion) schemes must be regarded as "frivolous or groundless." Sec. 6673.

To reflect the foregoing,

Decisions will be entered for the respondent.

STAMM INTERNATIONAL CORP., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 5543–84. Filed February 25, 1985

On Dec. 8, 1983, respondent sent P a notice of deficiency for 1978, 1979, 1980, and 1981. P had previously received a notice of deficiency for 1978. P filed petitions from both notices. P later moved to dismiss as to all years on the basis that the notice of Dec. 8, 1983, was a second notice of deficiency as to 1978 and therefore was invalid and could not be the basis of the Court's jurisdiction over the years set forth in such notice. *Held*, the notice of deficiency of Dec. 8, 1983, was an invalid second notice for 1978, and the Court has no jurisdiction over 1978 from that notice. *Held, further*: That the invalidity of the notice for 1978 does not affect the Court's jurisdiction over the 1979, 1980, and 1981 taxable years. A statutory notice which sets forth several separate taxable years is divisible: the notice may be valid as to certain years even though it is invalid as to others.

E. A. Dominianni, for the petitioner.

Robert B. Marino and *Raymond J. Farrell*, for the respondent.

OPINION

GERBER, *Judge*: By statutory notice dated December 8, 1983, respondent determined deficiencies in petitioner's Federal corporate income and personal holding company tax as to the

taxable years ended June 30, 1978, 1979, 1980, and 1981, in the amounts of $569,399, $909,614, $1,265,764, and $1,647,793, respectively. Petitioner had previously received a statutory notice for the taxable year ended June 30, 1978, in which a deficiency was determined in a lesser amount ($123,842).

This case is now before the Court on petitioner's motion to dismiss for lack of jurisdiction as to all 4 taxable years. We are asked to decide whether a statutory notice that determines deficiencies for several taxable years, which is a second notice as to one of the years, can be the basis for the jurisdiction of the Court.

Petitioner Stamm International Corp. is a corporation with its principal office located at 321 Commercial Avenue, Palisades Park, New Jersey 07650. For its taxable years ended June 30, 1978, 1979, 1980, and 1981, petitioner filed returns with the Internal Revenue Service Center at Holtsville, New York.

By written agreements pursuant to section 6501(c)(4),[1] petitioner and respondent extended the period for assessment of tax due for the taxable years ended June 30, 1978 and 1979, to December 31, 1983. For the taxable year ended June 30, 1980, the statutory period for assessment expired on December 11, 1983.[2]

On November 3, 1983, and on December 8, 1983, respondent sent statutory notices to petitioner, and copies of the statutory notices to petitioner's representatives. The record in this case concerning the issuance of statutory notices is unduly burdensome. Multiple notices were sent to various addresses, some of which were incorrect. Pursuant to a power of attorney, petitioner's representatives were entitled to receive copies of notices concerning the taxable year ended June 30, 1978.

For purposes of this case, however, it is important to note the following. For the taxable year ended June 30, 1978,

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years at issue.

[2] Petitioner concedes that the period of limitations for the taxable year ended June 30, 1978, would have expired on Dec. 31, 1983, and has not contested respondent's assertion that the period of limitations for 1979 and 1980 expired as indicated.

The record does not disclose why the statutory period for assessment for the 1980 taxable year would have expired on Dec. 11, 1983.

The record also does not indicate when the statutory period for assessment with respect to the 1981 taxable year would have expired. In general, a tax must be assessed within 3 years of the filing of a return. Sec. 6501.

petitioner received and timely petitioned from a copy of a November 3, 1983, notice sent to its representatives. The other November notices that respondent attempted to send to petitioner were incorrectly addressed and were returned to respondent undelivered. Several notices were sent to the correct addresses of petitioner and its representatives on December 8, 1983. From these notices, two petitions were filed, one for the taxable year ended June 30, 1978, and the other for the taxable years ended June 30, 1978, 1979, 1980, and 1981. From this overabundance of notices and petitions, the issue of the divisibility of a notice has arisen.[3]

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[3]For purposes of completeness, we provide the following list of statutory notices and copies of statutory notices.

STATUTORY NOTICES AND COPIES OF NOTICES MAILED BY RESPONDENT

Where and to whom sent	*Date sent*	*Taxable years affected June 30—*	*Deficiency amounts asserted*	*Ultimately received by petitioner*	*Action taken by petitioner*
Stamm International Corp. 321 Commercial Ave. Palisades, N.J. 07024	Nov. 3, 1983	1978 1979 1980 1981	$123,842 121,295 277,912 487,682	No	None
Stamm International Corp. 400 Commercial Ave. Palisades, N.J. 07024	Nov. 3, 1983	1978 1979 1980 1981	123,842 121,295 277,912 487,682	No	None
Stamm International Corp. 400 Commercial Ave. Palisades, N.J. 07024	Nov. 3, 1983	1978	123,842	No	None
Emilio A. Dominianni, Esq. Coudert Brothers 200 Park Ave. New York, N.Y. 10166	Nov. 3, 1983	1978	123,842	Yes	Filed petition in docket No. 2690-84
Michael S. Wolff, C.P.A. Alexander Grant & Co. 605 Third Ave. New York, N.Y. 10016	Nov. 3, 1983	1978	123,842	Yes	
Stamm International Corp. 321 Commercial Ave. Palisades Park, N.J. 07650	Dec. 8, 1983	1978 1979 1980 1981	569,399 909,614 1,265,764 1,647,793	Yes	Filed petition in docket No. 5543-84
Emilio A. Dominianni, Esq. Coudert Bros. 200 Park Ave. New York, N.Y. 10166	Dec. 8, 1983	1978	569,399	Yes	Filed petition in docket No. 4865-84
Michael S. Wolff, C.P.A. Alexander Grant & Co. 605 Third Ave. New York, N.Y. 10016	Dec. 8, 1983	1978	569,399	Yes	

On August 22, 1984, this Court heard oral argument on petitioner's motion to dismiss docket Nos. 5543–84[4] (this action) and 4865–84[5] for lack of jurisdiction. Petitioner argued that as to the taxpayer, taxable year, and taxes involved, the notice of deficiency in docket No. 4865–84 was duplicative of the notice in docket No. 2690–84.[6] Respondent did not object to petitioner's motion to dismiss docket No. 4865–84. The Court entered an order dismissing the action in docket No. 4865–84 and took petitioner's motion in this action under advisement.

Petitioner, in its motion, contends that the notice of deficiency in this action is invalid as to 1978 because it is a second notice as to that year; that, because the notice is invalid as to one year, it is invalid as to all years; and, therefore, the Tax Court lacks jurisdiction.[7] Respondent agrees that the notice is invalid as to the taxable year ended June 30, 1978, but asserts that the notice is nevertheless valid for the taxable years ended June 30, 1979, 1980, and 1981, and concludes that the Tax Court has jurisdiction as to the 3 latter years.[8] We agree with respondent's position.

We are unaware of any opinion that has focused on the issue presented in this case. Because our jurisdiction is statutorily limited, the Internal Revenue Code must be the starting point for our analysis. Where the Secretary of the Treasury determines a deficiency in tax, the Secretary is authorized under section 6212(a) to send notice of the deficiency to the taxpayer involved. The notice of deficiency is sufficient if mailed to the taxpayer at his last known address. Sec. 6212(b). As to subsequent notices of deficiency, section 6212(c), in pertinent part, provides as follows:

SEC. 6212(c). FURTHER DEFICIENCY LETTERS RESTRICTED.—

(1) GENERAL RULE.—If the Secretary has mailed to the taxpayer a notice of deficiency as provided in subsection (a), and the taxpayer files a petition with the Tax Court within the time prescribed in section 6213(a), the

[4] Involving all 4 taxable years and arising from a Dec. 8, 1983, notice.

[5] Involving the taxable year ended June 30, 1978, only, and arising from a Dec. 8, 1983, notice.

[6] Involving the taxable year ended June 30, 1978, only, and arising from a copy of the Nov. 3, 1983, notice sent to petitioner's representatives.

[7] Were we to find the notice in this action entirely invalid, expiration of the statutory period for assessment for 1978, 1979, and 1980 would prevent respondent from again issuing notices for those years.

[8] Respondent maintains that the petition in this action does not give the Court jurisdiction over 1978, but that the petition in docket No. 2690–84 does.

Secretary shall have no right to determine any additional deficiency of income tax for the same taxable year * * *

In the matter before us, notices of deficiency were mailed on November 3 and December 8, 1983.[9] Petitioner filed a petition (docket No. 2690–84) from a copy of a statutory notice for 1978 mailed to its representatives on November 3.[10] Petitioner also filed a petition (this action) based on the notice of deficiency for the taxable years ended June 30, 1978, 1979, 1980, and 1981, mailed to it on December 8, 1983. Where a taxpayer files a petition from a notice of deficiency, respondent has no authority to send the taxpayer a second notice for the same taxable year and tax liability. *Barth Foundation v. Commissioner*, 77 T.C. 1008, 1013 (1981); *McCue v. Commissioner*, 1 T.C. 986 (1943). Accordingly, the notice of deficiency in this action, which was a second notice as to the taxable year ended June 30, 1978, is invalid for that year. A valid petition is the basis of the Tax Court's jurisdiction. To be valid, a petition must be filed from a valid statutory notice. See *Midland Mortgage Co. v. Commissioner*, 73 T.C. 902, 907 (1980); *McCue v. Commissioner, supra* at 988. The Court therefore has no jurisdiction as to the taxable year ended June 30, 1978, from the petition filed in this action since the petition is invalid as to that year.

In order to decide whether the statutory notice of deficiency in this action is nevertheless valid as to the taxable years ended June 30, 1979, 1980, and 1981, we must consider the function of the notice. A statutory notice of deficiency is a jurisdictional prerequisite to a taxpayer's suit seeking the Tax Court's redetermination of respondent's determination of the tax liability. *Laing v. United States*, 423 U.S. 161, 165 n. 4 (1976). No particular form is required for a statutory notice of deficiency. *Scar v. Commissioner*, 81 T.C. 855, 860 (1983); *Foster v. Commissioner*, 80 T.C. 34, 229 (1983), on appeal (9th Cir., Sept. 30, 1983); *Jarvis v. Commissioner*, 78 T.C. 646, 655

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[9] The notices of deficiency mailed on Nov. 3 to Palisades, New Jersey, were nullities because they were not sent to petitioner's last known address and were undelivered. See *Reddock v. Commissioner*, 72 T.C. 21, 27 (1979).

[10] This document reflects petitioner's address as 321 Commercial Avenue, Palisades, New Jersey 07204. The record suggests that this document is a copy of a notice for the taxable year ended June 30, 1978, the original of which petitioner never received.

Petitioner's representatives also received a copy of the statutory notice for 1978 mailed to petitioner at 400 Commercial Avenue, Palisades, New Jersey 07024.

(1982). All that is required is that the notice provide formal notification that a deficiency in tax has been determined.[11] *Foster v. Commissioner, supra* at 229. "[T]he notice is only to advise the person who is to pay the deficiency that the Commissioner means to assess him; anything that does this unequivocally is good enough." *Olsen v. Helvering*, 88 F.2d 650, 651 (2d Cir. 1937).

Petitioner asserts, "where a court's jurisdiction over a matter is strictly statutory,[12] there must be complete and exact compliance with the statutory requirements before jurisdiction is perfected." Petitioner cites numerous cases, none of which concern Federal taxation, for the proposition that a notice of deficiency that spans several tax years must be valid for each year in order for this Court to have jurisdiction over any of the years. Statutory and case law on Federal taxation, however, simply do not support petitioner's position.

As our decision in *Baron v. Commissioner*, 71 T.C. 1028 (1979), illustrates, a statutory notice is not wholly invalid where the petition filed from it is invalid in part for lack of jurisdiction. In *Baron v. Commissioner, supra*, a notice of deficiency was jointly issued to a husband and wife, who petitioned the Tax Court for redetermination of their tax liability. The statutory notice was sent after the husband had been adjudicated a bankrupt. The taxpayers argued that under section 6871(b),[13] the Tax Court lacked jurisdiction as to

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[11] Where a valid notice of deficiency is mailed to the wrong address, the Tax Court may nevertheless have jurisdiction. See, e.g., *Mulvania v. Commissioner*, 81 T.C. 65 (1983) (notice of deficiency received by taxpayer's former wife at what may not have been taxpayer's last known address and given to him 16 days later, valid because taxpayer received it early enough to file a timely petition); *Frieling v. Commissioner*, 81 T.C. 42 (1983) (notice of deficiency, though not sent to taxpayer's last known address, valid where taxpayer actually received the notice within 90 days of its mailing and timely filed a petition).

[12] As petitioner correctly notes, the jurisdiction of the Tax Court derives from sec. 7442 and is strictly statutory.

[13] For the taxable year at issue, sec. 6871(b) read as follows:

SEC. 6871. CLAIMS FOR INCOME, ESTATE, AND GIFT TAXES IN BANKRUPTCY AND RECEIVERSHIP PROCEEDINGS.

(b) CLAIM FILED DESPITE PENDENCY OF TAX COURT PROCEEDINGS.—In the case of a tax imposed by subtitle A or B claims for the deficiency and such interest, additional amounts, and additions to the tax may be presented, for adjudication in accordance with law, to the court before which the bankruptcy or receivership proceeding is pending, despite the pendency of proceedings for the redetermination of the deficiency in pursuance of a petition to the Tax Court; but no petition for any such redetermination shall be filed with the Tax Court after the adjudication of bankruptcy, the filing or (where approval is required by the Bankruptcy Act) the approval of a petition of, or the approval of a petition against, any taxpayer in any other bankruptcy proceeding, or the appointment of the receiver.

the husband and therefore the statutory notice was null as to him; and that, because the notice had been issued jointly, it was null as to the wife as well. Although we agreed with the taxpayers that the Tax Court had no jurisdiction over the husband, we nevertheless found the statutory notice valid with respect to the wife and held that the Tax Court had jurisdiction as to her, since she was a separate taxpayer and section 6871(b) did not prohibit *her* from filing a petition with the Court.

The jurisdiction of the Tax Court over separate taxable years, rather than as to separate taxpayers, is at issue in this case. Taxes are levied annually, and each taxable year may be the basis of a separate cause of action. *Commissioner v. Sunnen*, 333 U.S. 591, 598 (1948). Where the Commissioner determines a deficiency as to several taxable years, the taxpayer may petition the Tax Court to redetermine the deficiency as to any or all of the years. *John R. Thompson Co. v. Commissioner*, 10 B.T.A. 57, 61 (1928). For example, where the Commissioner in a statutory notice determines a deficiency as to two separate taxable years, the taxpayer may file a petition with respect to one or both years (or may file no petition and pay the determined deficiencies). Likewise, a taxpayer may file one petition contesting deficiencies determined for multiple years in separate notices. *Egan v. Commissioner*, 41 B.T.A. 204 (1940). In *Baron v. Commissioner, supra*, we held that a statutory notice sent jointly to separate taxpayers was valid as to one taxpayer, even though the Tax Court lacked jurisdiction as to the other taxpayer. Similarly, we regard a notice as to several separate taxable years as divisible: the notice may be valid with respect to certain taxable years even though, with respect to other years, the notice is invalid and the Tax Court consequently lacks jurisdiction. Cf. *S-K Liquidating Co. v. Commissioner*, 64 T.C. 713 (1975).

In the matter before us, had respondent on December 8, 1983, sent petitioner separate notices of deficiency for the taxable years ended June 30, 1978, 1979, 1980, and 1981, and had petitioner timely filed separate petitions for each of those years, the Court would have had jurisdiction as to the taxable years ended June 30, 1979, 1980, and 1981. We know of no reason to reach a different result because respondent used one

notice determining deficiencies in each of 4 separate taxable years, from which a single petition was filed.

The statutory notice in this action advised petitioner that the Commissioner had determined deficiencies in petitioner's taxable years ended June 30, 1979, 1980, and 1981, in amounts that the notice set forth.[14] That was all that was necessary for the notice to be valid for those years. See *Scar v. Commissioner, supra* at 860–861; *Foster v. Commissioner, supra* at 229–230. We hold that the petition filed from the instant notice gave this Court jurisdiction over the deficiencies respondent determined for the taxable years ended June 30, 1979, 1980, and 1981.

Accordingly, petitioner's motion to dismiss will be granted as to the taxable year ended June 30, 1978, and denied as to the taxable years ended June 30, 1979, 1980, and 1981. To reflect the foregoing,

An appropriate order will be entered.

GOODSON-TODMAN ENTERPRISES, LTD., AND ITS SUBSIDIARY CORPORATIONS, MID-HUDSON PUBLICATIONS, INC., CACTUS PRODUCTIONS, INC., ULSTER OFFSET CORP., PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 10604–81. Filed February 25, 1985.

Petitioner is the producer of the game show, "To Tell The Truth" (TTIT). During the years in question, petitioner claimed investment tax credits for its costs incurred in connection with the production, for syndication, of TTTT tapes. Respondent disallowed the credits based on his determination that the tapes did not qualify for the investment tax credit under secs. 38 and 48(k)(1)(B), I.R.C. 1954. *Held*: Petitioner's TTTT tapes constituted qualified films within the meaning of sec. 48(k)(1)(B), since they were "created primarily for use as public entertainment" and since the market for those tapes was not "primarily topical" or "otherwise essentially transitory in nature." Petitioner, therefore, is entitled to claim the investment tax credit with respect to those tapes. Scope of sec. 1.48–8(a)(3)(iii), Income Tax

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[14] As we have discussed, the Commissioner also determined a deficiency as to 1978, but the notice was an invalid second notice as to that year.

Regs., considered and respondent's interpretation thereof rejected.

Robert A. Schulman, Lyman G. Friedman, and *J. Alan Galbraith,* for the petitioners.*

Theodore J. Kletnick, David M. Brandes, and *Dennis M. Bresnan,* for the respondent.

STERRETT, *Judge*: In his notice of deficiency dated March 26, 1981, respondent determined deficiencies in petitioners' Federal income taxes for the taxable years ended March 31, 1973, March 31, 1974, and March 31, 1977, in the respective amounts of $33,604, $160,587, and $11,482.[1] The ultimate issue for decision is whether, pursuant to sections 38 and 48(k), I.R.C. 1954, petitioners are entitled to claim investment tax credits with respect to the videotaped television series, "To Tell The Truth."

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts, together with the exhibits attached thereto, is incorporated herein by this reference.[2] Goodson-Todman Enterprises, Ltd. (hereinafter referred to as petitioner), is a corporation duly organized and existing under the laws of the State of New York. At the time the petition in this case was filed, petitioner's principal place of business was located in New York, New York. Petitioner's subsidiary corporations, Mid-Hudson Publications, Inc., Cactus Productions, Inc., and Ulster Offset Corp., are involved in this proceeding only by reason of having filed consolidated income tax returns with petitioner.

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*Brief amici curiae was filed by Sheldon S. Cohen, Roger A. Pies, and Howard J. Hoffman as attorneys for Barry Productions, Inc., and Enright Enterprises, Inc.

[1] Investment tax credits claimed by petitioners for the taxable years 1975, 1976, and 1978, and carried over and carried back to the taxable years for which the deficiencies were determined were also disallowed by respondent and therefore are in issue in the instant case.

[2] In their briefs, the parties refer to this case as being "submitted fully stipulated" or submitted with "a complete Stipulation of Facts." This case, however, was not submitted pursuant to Rule 122, Tax Court Rules of Practice and Procedure, and each party has objected to the opposing party's proposed findings of fact. The objections relate to the proper inferences to be drawn from documents stipulated into evidence. We have made our own findings based on the stipulation of facts and the documents stipulated into evidence.

Since the early 1950s, the principal business of petitioner and related entities has been the production of television programs. Petitioner is an established producer in the television industry. Among other productions, petitioner and its related entities have produced "What's My Line?", "I've Got a Secret", "Password", "Family Feud", "The Price is Right", and "Beat The Clock".

In the fall of 1956, petitioner commenced production of the television series "To Tell The Truth" (hereinafter referred to as TTTT). Production of this series was the principal business activity of petitioner. TTTT was successful. It was televised during both prime time and daytime over the CBS network from 1956 through 1969. From 1969 through 1980, the series was taped to be syndicated to various stations throughout the United States. The syndicated shows were produced during the years that are before the Court.

TTTT's format remained substantially the same throughout its history. Each TTTT show was one-half hour in duration and normally consisted of two "spots." Each show was taped before a live audience and subsequently televised. Appearing on each show were a master of ceremonies or "emcee," four celebrity panelists, and contestants (three per spot). The emcee and celebrity panelists were permanent members of the TTTT series and regularly appeared on numerous shows throughout the "season." Each was recognized by the viewing public as an entertainment personality or celebrity. The emcees included such widely known persons as Bud Collyer, Garry Moore, Bill Cullen, and Joe Garagiola. The celebrity panelists included hosts of other game shows, actors and comedians, TV news people, commentators, sportscasters, athletes, and former politicians. Specifically, panelists included such people as Gene Rayburn, Allen Ludden, Kitty Carlisle, Peggy Cass, Nipsey Russell, Hugh Downs, and Dick Clark. The three contestants used in each spot were comprised of a "real person" and two "imposters."

At the beginning of each TTTT show, the announcer introduced the emcee, who made a brief statement introducing the first spot. The four celebrity panelists were then introduced, followed by the appearance on the stage of the three contestants involved in the first spot. Each contestant would announce that he was the particular real person who was the

subject of the spot. Of course, only one contestant was the real person. The other two contestants were imposters. The emcee then read a short prepared statement or "affidavit" that related the story of the real person. A sample prepared statement is as follows:

> I, John Fulton Short, an American, am a professional bullfighter and illustrator. I have fought bulls and exhibited my paintings in both Mexico and Spain where I am known as "El Yanqui." I fought my first bull in 1953, and, to date, I have fought and killed 53 bulls.
>
> Signed John Fulton Short

The affidavit having been read, each member of the panel in turn then asked questions of each contestant. The panelists' goal was to identify the real person. Each panelist had one minute in which to question the contestants and within that alloted time was able to ask five to seven questions. The ringing of a bell marked the end of questioning by each panelist.

The real person was required to answer all questions truthfully. The imposters were not required to do so. Instead, they attempted to assume the identity of the real person and answered questions accordingly in an attempt to mislead the panelists.

Once all the questioning was completed, each panelist marked on a card the number 1, 2, or 3 to designate his selection of the particular contestant he believed to be the real person. The panelists might state some reason, humorous or serious, to explain his vote. Next, the emcee would ask the real person to identify himself, for example, "Will the real John Fulton Short please stand up." The real person and the imposters then would engage in a discussion with the emcee and the panelists with respect to details of their lives.

The outcome of each particular spot was undetermined at the time the spot started. The panelists competed individually against the contestants and each other. The panelists were instructed by the producers of TTTT not to reveal any information that would lead to identification of the real person by the other panelists and thereby eliminate the competitive factor. The three contestants were each guaranteed $50 for appearing on TTTT, and, if all four panelists voted incorrectly, the three contestants divided $500. In addition to the cash

awards, the contestants were given gifts of nominal value, such as costume jewelry, perfume, etc., supplied by advertisers. Some contestants were reimbursed for travel expenses.

An individual was selected to participate on TTTT as a "real person" because of his connection with an event, achievement, or happening that petitioner perceived to be of interest to the television audience. TTTT had the same audience appeal as such contemporary shows as "Real People" and "That's Incredible." A common characteristic of TTTT and these shows is that they all communicate a noteworthy aspect of an individual that is of interest to the viewing public. Set forth below is a representative list and brief descriptions of certain real persons who appeared on TTTT shows that were taped between April 8, 1975, and March 30, 1976, for telecasting during the season commencing in the fall of 1975.

Roy Volker is a professional treasure hunter. As such, he found the single most valuable coin ever discovered—the 1715 Eight Escuedo Spanish Gold Royale. He's written a book for potential treasure hunters which informs you, not only where to search, but also how to clean, care for and dispose of what you find. It's titled TREASURE UNDER YOUR FEET.

Ed Feinhandler won the ugly man contest for 4 years. He's the first person to win the title 3 consecutive times since the contest began back in 1961 and the only one to win without the use of makeup.

Benson Huggard is a long-distance swimmer. He began distance swimming in 1961 when he bet a lady 14 years his senior...he lost the bet. Since then he's broken ten world records.

Traphes Bryant has served the equivalent of six terms in the White House...mostly in the dog house. He's been the kennel keeper at the White House for four presidents.

George Sroda is an oligo-chaetologist...and expert on worms. At present, he owns the nation's largest experimental worm laboratory and owns two million worms.

Arthur Weiner has crashed over one thousand parties. As New York City's most un-invited guest, he's barged in on every conceivable type of function—after theatre parties, fashion shows, art gallery galas, etc.

Joan Haas is a former model and hairdresser. Her business career ended because of her increasingly worsening health...Bright's Disease. Since then, she's had 21 major operations and quite literally is part human and part machine. In some medical circles, she is known as "the six million dollar woman."

Theodore W. Roth is considered to be America's foremost probate investigator. As head of "MISSING HEIRS, INTERNATIONAL", he has travelled all over the world finding missing heirs.

Anna Leider won first prize in the National Football League Bicentennial Scholarship Essay Contest. For winning the contest, she received an NFL watch and pendant, a birthday call from Commissioner Rozelle, and a $10,000 scholarship for the college of her choice.

Cecil Saxby is the retired chief of detectives for Scotland Yard. Mr. Saxby was one of the men responsible for rounding up the perpetrators of the notorious London train robbery.

Theodora Fitzgibbon has authored a gaggle of books on food. Her latest traces the origins, history and recipes of those comestibles that are popular in Europe and North America.

[Reproduced literally.]

TTTT's staff continuously did research in order to maintain and add to TTTT's files pertaining to potential real persons and likely imposters who might be selected to appear on unspecified future shows. Although individual shows required varying amounts of preparation time, preparation of a typical TTTT show had to be commenced many months in advance of its taping. In connection with their research, staff members read books, magazines, and 30 to 50 newspapers a week. TTTT's staff often selected as "real persons" people who had received coverage in newspaper articles. At times, the staff received referrals from public relations contacts.

Although ideas for real person selections were sometimes derived from newspapers, in selecting spots for the syndicated TTTT shows, Mark Goodson, petitioner's president, did not desire to use real persons whose stories could be described as material for contemporaneous headline features in the news media, but instead preferred real persons with more general stories. In Mr. Goodson's view, general stories, while frequently also newsworthy, retained audience appeal longer than headline features and accordingly were more suitable for syndication. There were instances when a real person appearing on TTTT also appeared on variety and interview shows such as "The Today Show."

After the number of potential real persons was narrowed down, those remaining under consideration as potential real persons had to be interviewed by TTTT's staff for personality, audience appeal, stage presence, and ability to undergo ques-

tioning by, and engage in small talk with, the celebrity panelists and the emcee.

After the real person for a particular TTTT spot was selected, potential imposters had to be located and interviewed. Imposters were selected, in part, on the basis of their audience appeal, stage presence, and ability to undergo questioning and to engage in small talk. In addition, imposters had to possess characteristics and personalities that would make it likely for them to be mistaken by the panelists for the real person. On occasion, the TTTT production staff had difficulty locating suitable imposters and found it necessary to resort to stopping people on the street in search of imposters. Once imposters were selected, they had to be briefed by TTTT's production staff and prepared to emulate the real person. In addition, all contestants, the real person and the imposters, would participate in an orientation session during which the contestants familiarized themselves with the set and format of the show. The efforts of the TTTT production staff in preparing imposters to act out the real person were essential to the success of TTTT. The importance of the staff's efforts has been described as follows:

> The solution to playing *To Tell The Truth* * * * lay in exhaustive briefing. Having rounded up two plausible-looking imposters to appear with a truth-teller, all three of them offering the same implausible story, * * * [the] staff would have to be willing, year in, year out, to spend several hours before each show with each team, forcefeeding them every conceivable fact about the person they'd be impersonating, coaching them on every related subject about which they would have to be knowledgeable. The procedure would be very much like cramming for an exam * * *. To further hone them for their ordeal, * * * [a member of TTTT's staff] would first have * * * [the] impersonators take part in a dress rehearsal in front of a stand-in panel whose job it was to try to trip them up.[3]

Unlike the contestants, the celebrity panelists and the emcee did not rehearse prior to the taping of the TTTT show. The show was unscripted, except for brief introductory remarks, the affidavit, and certain incidental remarks.

TTTT was commonly known in the television industry as a game show and was marketed and promoted as such. The production staff and the celebrity panelists considered TTTT

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[3] M. Fabe, TV Game Shows 171–172 (1979).

to be a game show as that term is used within the industry. Mr. Goodson has stated on many occasions that "TTTT was the most golden game show idea of all." Unlike many game shows, however, TTTT did not generate audience appeal by rewarding participants with large prizes. Rather, TTTT's emphasis was on presenting human interest stories through the format of a game. In the view of the producers, the story of the real person, the verbal interplay among the celebrity panelists, the emcee, and the contestants, and the viewing public's participation in the selection process were the features of the show that generated audience appeal and resulted in a marketable television series.

During petitioner's fiscal years ended March 31, 1970, through March 31, 1978, petitioner derived income from shows taped for its "seasons" I, II, III, IV, V, VI, VII, VIII, and IX. A "season," as used herein, means the series of shows intended to be shown over a 52-week period commencing in the fall of one year and running into the next year. During the years in issue, TTTT was taped to be syndicated to various television stations throughout the country. One week's set of five shows would be taped on one day of the week. At that same time, five additional shows for taping the next week would be in the final stages of preparation, and the five shows to be taped two weeks thereafter would be in more preliminary stages of preparation. The programs were distributed by an independent sales representative, who was paid a commission for arranging to license TTTT to individual television stations. Different licensees of TTTT televised different shows on different dates from other licensees. A method known in the industry as "bicycling" was employed to distribute the TTTT tapes to the various television stations airing the show across the country. The TTTT tapes were rotated, on a geographic basis, among stations for televising. For example, a specific show would be televised in successive weeks in Philadelphia, Harrisburg, Pittsburgh, Buffalo, Scranton, etc.

In a typical season, petitioner produced 195 taped TTTT shows. TTTT's licensee was obligated to televise the number of weeks of shows that were produced (often 39 weeks), and the licensee was further obligated to fill out the year with reruns selected exclusively by petitioner from the same 39 weeks of shows. Thus, at a minimum, 13 weeks of shows (65 shows) were

rerun by every station licensed to televise TTTT programs during the license year.[4] As a rule of thumb, roughly 25 percent of the TTTT shows were rerun on a particular station to fill out or complete the season.

The parties have stipulated that, during the years involved herein, there were approximately 22,419 showings of weeks of TTTT shows on television stations in the United States.[5] The 22,419 total showings of weeks of TTTT shows were comprised of approximately 16,373 initial showings and 6,046 reshowings on the same stations. Three hundred and ten shows (1.38 percent) were rerun by a particular station more than 52 weeks after the initial showing on that station.[6] As a result of several factors, including the bicycling method of distribution and the adding of another station in a subsequent season to the syndicated list, initial showings on certain stations occurred in subsequent seasons. A total of 4,227 (18.85 percent) repeat showings of weeks of tapes were telecast on a particular station during a season (September 1 through August 31) following that in which some television stations had first televised them. Generally, the last showing anywhere occurred within 2 years of the initial showing.[7]

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[4] In some seasons, the 52 weeks of shows were comprised of 35 weeks of new shows and 17 weeks of reruns.

[5] This number was computed by multiplying the number of stations televising TTTT shows by the number of weeks televised. In the aggregate, individual shows of TTTT were telecast approximately 110,000 times on television stations in the United States.

[6] The 310 shows referred to were generally individual shows rather than full weeks of shows, and the rerun percentage is actually somewhat overstated.

[7] The following excerpt from one of the documents stipulated into evidence may help the reader visualize the foregoing statistical analysis:

Show number	*Date taped*	*First date shown*	*Last initial showing*	*Last date shown*	*Number of weeks shown*
118	2/29/72	8/28/72	12/16/74	12/16/74	49
119	3/07/72	9/04/72	12/23/74	12/23/74	45
120	3/14/72	9/11/72	12/30/74	12/30/74	48
121	3/21/72	9/11/72	1/06/75	1/06/75	48
122	3/28/72	9/18/72	2/03/75	2/03/75	48
123	4/04/72	9/11/72	1/06/75	1/06/75	51
124	4/11/72	9/11/72	8/12/74	12/30/74	78
125	4/18/72	9/18/72	1/13/75	1/13/75	45
126	4/25/72	9/25/72	12/09/74	12/09/74	48
127	5/02/72	10/02/72	8/05/74	12/30/74	78
128	5/09/72	10/09/72	12/16/74	12/16/74	48
129	5/16/72	10/16/72	8/26/74	10/21/74	81
130	5/23/72	10/23/72	12/23/74	5/05/75	46

The celebrity panelists and the emcee provided their services under separate contracts with petitioner. These contracts provided that the panelists and emcee would be compensated for a fixed number of shows per week (usually five shows) and also provided that they would be paid additional compensation if the particular show in which the individual performed was selected by petitioner to be one of the shows to be rerun. The panelists and the emcee were paid for subsequent showings in accordance with their separate agreements with petitioner.

A permanent TTTT staff of not less than 15 people was required to perform all functions preparatory to the taping of the TTTT shows. In addition, each TTTT show required a cast of 4 panelists, 1 announcer, 1 emcee, and 6 or 9 contestants. Finally, 24 or more people were made available to TTTT, for a fee, by a television network for purposes of actually taping the shows. These people included, among others, camera persons, stagehands, wardrobe handlers, makeup artists, and audio and lighting technicians. In the aggregate, 49 to 54 persons were involved in the process of preparing, performing, and taping each individual half-hour show.

All costs incurred by petitioner in connection with the production of TTTT were incurred in the United States. These costs were reported by petitioner in its Federal income tax returns for all years here material and were recognized by respondent as capital in nature, to be recovered by depreciation through the "income forecast method" over the economic lives of such tapes, and not as current expenses deductible at the time paid or incurred. The following schedule sets forth petitioner's "income forecast method" of recovering its costs of TTTT tapes placed in service during the years in issue:

Placed in service FYE—	*Approximate percentage recovered first year*	*Approximate percentage recovered second year*	*Approximate percentage recovered third year*
1973	16%	59%	25%
1974	27	56	17
1975	31	51	18
1976	27	55	18
1977	30	62	8
1978	54	42	4

Petitioner claimed investment tax credits and carryovers and carrybacks of such credits for its costs incurred in connection with TTTT under the method provided in section 48(k)(2), I.R.C. 1954. There is no dispute between petitioner and respondent over the amount of the investment tax credits to which petitioner is entitled if petitioner is otherwise entitled to claim such credits. The following schedule sets forth the amounts of those credits:

FYE—	Credit	FYE—	Credit
1973	$32,059	1976	*$130,160
1974	35,634	1977	113,416
1975	41,547	1978	152,285

Respondent's statutory notice of deficiency disallowed the claimed investment tax credits, stating as follows:

It is determined that the investment credits claimed in the amount of $32,059.00; $35,634.00; $41,547.00; $65,080.00; $113,416.00; and $152,285.00, respectively, (a total of $440,021.00) for the respective taxable years ended March 31, 1973 through March 31, 1978 inclusive, on video tapes of the program "To Tell The Truth" are disallowed because the property does not qualify for the investment credit under sections 38 and 48(k)(1)(B) of the Internal Revenue Code.

OPINION

Section 48(k)(1) provides, in part, that an investment tax credit is allowable to a taxpayer with respect to any motion picture film or video tape if such film is new section 38 property (determined without regard to useful life) and if such film is a qualified film. In defining a qualified film, section 48(k)(1)(B) provides as follows:

(B) QUALIFIED FILM DEFINED.—For purposes of this subsection, the term "qualified film" means any motion picture film or video tape created primarily for use as public entertainment or for educational purposes. Such term does not include any film or tape the market for which is primarily topical or is otherwise essentially transitory in nature.

Respondent, in section 1.48–8(a)(3)(iii), Income Tax Regs., has interpreted the foregoing language as follows:

*The amount of the 1976 credit claimed on petitioner's return was increased by the examining agent.

(iii) *Topical or transitory films and tapes.* The term "qualified film" does not include any film or tape the market for which is primarily topical or is otherwise essentially transitory in nature. *A film or tape is topical or essentially transitory in nature if it primarily deals with events and personalities of current interest at the time the film or tape is placed in service.* It does not matter that a film or tape which is topical or essentially transitory in nature may be shown in subsequent years or is actually shown in subsequent years. These films or tapes include news shows such as the evening news and news specials relating to current affairs, interview shows such as "The Tonight Show" or "Meet the Press", *game shows*, award shows, and shows consisting of sporting events. Similarly, variety shows do not qualify for the credit since they present entertainers primarily as personalities of current interest, as opposed to dramatic or situation comedy shows which present entertainers as characters in a dramatization. Topical or transitory films and tapes do not include, however, dramatized recreations of recent events. [Emphasis added.]

Petitioner's primary position is that the market for TTTT tapes was neither "primarily topical" nor "essentially transitory" within the meaning of section 48(k)(1)(B) and, therefore, that it is entitled to the investment tax credit (ITC) irrespective of whatever meaning may attach to section 1.48–8(a)(3)(iii), Income Tax Regs. Petitioner would have us hold that the regulation is invalid at least in part, on the grounds that it not only exceeds the scope of the statutory provision it purports to administer, but also is inconsistent with the language of the statute. In addition, petitioner contends that to the extent that the regulation imposes a blanket rule that game shows are to be denied the investment tax credit, promulgation of the regulation violated the Administrative Procedure Act (5 U.S.C. sec. 553, et seq.) because the provision concerning game shows was not included in the proposed regulations, as published in the Federal Register, but was added to the final regulations without any further publication or notice that game shows would be dealt with in the regulations. Petitioner alternatively contends that this Court could sustain the regulation and still hold for petitioner by reading the regulation's game show provision in a restrictive manner. One suggestion advanced by petitioner is that the Court distinguish between various game shows and conclude that a show such as TTTT, in which the "game" aspect is subordinate to the presentation of durable human interest stories, is not included in the term "game shows" as used in section 1.48–8(a)(3)(iii), Income Tax Regs. Another suggestion

advanced by petitioner is that the Court read the game show provision to deny the ITC only to those game shows, the markets of which, *in fact*, are topical or transitory in nature, and find that the market for TTTT was not topical or transitory.

The primary thrust of respondent's counter to petitioner's position is that petitioner has failed to show that the Commissioner was arbitrary and capricious in promulgating the regulation at issue. Respondent, in fact, submits that the regulation is unassailable and fully consistent with the congressional mandate. In addition, respondent contends that the game show provision is not susceptible to the restrictive interpretation urged by petitioner. Instead, according to respondent, the game show provision removes game shows unqualifiedly from being eligible for the ITC. In short, it is respondent's position that petitioner cannot prevail herein unless petitioner can show that TTTT was not a game show or that section 1.48–8(a)(3)(iii), Income Tax Regs., is invalid.

We have not heretofore been called upon to address the parameters of section 1.48–8(a)(3)(iii), Income Tax Regs. Accordingly, we think it appropriate to begin by discussing the background leading up to the enactment of section 48(k) and the promulgation of the regulation in question.

Congress enacted the ITC provisions in the Revenue Act of 1962.[9] The stated purposes of the ITC was to encourage investment in the United States, thereby stimulating domestic employment and economic activity. S. Rept. 1881, 87th Cong., 2d Sess. (1962), 1962–3 C.B. 717.

Between the enactment of the original ITC legislation in 1962 and 1971, it was unclear whether (and if so, under what circumstances) the ITC was available for motion pictures or television films. However, in *Walt Disney Productions v. United States*, 327 F. Supp. 189 (C.D. Cal. 1971), aff'd. with modifications 480 F.2d 66 (9th Cir. 1973), cert. denied 415 U.S. 934 (1974), the court held that motion picture films were tangible personal property eligible for the ITC, and invalidated section 1.48–1(f), Income Tax Regs., to the extent that it required allocation of the entire production costs of film negatives to the intangible copyright. The legislative history of

[9] Pub. L. 87–834, sec. 2, 76 Stat. 962.

the Revenue Act of 1971[10] expressly approved the decision of the District Court in the *Disney* case. S. Rept. 92–437 (1971), 1972–1 C.B. 577–578.

Despite the *Disney* case and the expression of congressional approval, a number of issues surrounding the availability of the ITC with respect to films remained unresolved. Unsettled issues included the determination of the useful life of the film, the determination of the basis with respect to which the ITC was to be calculated, and the determination of the effect of predominant foreign usage of the film.

Congress believed it desirable to eliminate the uncertainties in the state of the law, to prevent costly litigation generated by these uncertainties, and to foster accurate investment planning for the movie industry in future years. H. Rept. 94–658 (1975), 1976–3 C.B. (Vol. 2) 880; S. Rept. 94–938 (1976), 1976–3 C.B. (Vol. 3) 223. Accordingly, Congress directly addressed the availability of the ITC by enacting section 48(k) as a part of the Tax Reform Act of 1976.[11] On the issue of useful life, Congress decided to allow taxpayers to take a two-thirds credit on all their qualified films, without regard to the useful lives of particular films. See section 48(k)(2); H. Rept. 94–658, *supra*, 1976–3 C.B. (Vol. 2) at 881; S. Rept. 94–938, *supra*, 1976–3 C.B. (Vol. 3) at 224. Alternatively, taxpayers are entitled to elect to determine useful life on a film-by-film basis, in which case the useful life of the film will be treated as having ended when 90 percent of the basis of the film is recovered through depreciation. See sec. 48(k)(3); H. Rept. 94–658, *supra*, 1976–3 C.B. (Vol. 2) at 881; S. Rept. 94–938, *supra*, 1976–3 C.B. (Vol. 3) at 224. On the issue of foreign usage, Congress recognized that the major purpose of the ITC is to create jobs in the United States and decided to provide that the amount of the ITC in the case of motion picture and television films is to depend generally on the place of production of the film, rather than on the place where revenues are received from showing the film. See sec. 48(k)(4); H. Rept. 94–658, *supra*, 1976–3 C.B. (Vol. 2) at 880–881; S. Rept. 94–938, *supra*, 1976–3 C.B. (Vol. 3) at 224.

In addition to addressing issues relating to useful life and foreign usage, Congress attempted to clarify in general which films would be eligible for the ITC. In this endeavor, Congress

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[10] Pub. L. 92–178, 85 Stat. 497.

[11] Pub. L. 94–455, sec. 804, 90 Stat. 1591.

enacted section 48(k)(1), the provision most directly applicable in the instant case. As noted previously, that section makes the ITC available only with respect to a "qualified film," which is defined to mean "any motion picture film or video tape created primarily for use as public entertainment or for educational purposes." The term "qualified film" expressly does not include "any film or tape the market for which is primarily topical or is otherwise essentially transitory in nature." The statute does not define the foregoing exclusionary language. Furthermore, the legislative history is not altogether illuminating with respect to the congressional intent underlying the statutory language in that it does not give a substantive explanation of that language but merely provides examples of films Congress considered as qualifying and nonqualifying. The relevant legislative history states as follows:

> For the future, as a general rule, * * * taxpayers are to receive two-thirds of a full credit for all their films regardless of the actual useful life (or foreign use) of any particular film. This rule will apply to all films placed in service * * * regardless of whether any particular film had a useful life of 7 years or more (so that it would be entitled to a full credit if judged on an individual basis), or less than 3 years (so that it would not be entitled to any credit if judged separately). The credit is to be available only for "qualified films", i.e., motion picture films or television films or tapes created primarily for use as public entertainment, and educational films, i.e., generally films used in primary or secondary schools, colleges and universities, vocational and post-secondary educational institutions, public libraries and government agencies (thus, for example, excluding industrial training films). Also, the credit would be available for TV pilot films and dramatic or comedy series, such as "Mod Squad" or "The Mary Tyler Moore Show." However, the credit would not be available for films which were topical or transitory in nature, such as news shows, interview shows such as "Johnny Carson" or "Firing Line", or films or tapes of sports events, even though some of these shows might be shown in subsequent years. * * * [S. Rept. 94–938, *supra*, 1976–3 C.B. (Vol. 3) at 224–225; fn. ref. omitted.]

See also H. Rept. 94–658, *supra*, 1976–3 C.B. (Vol. 2) at 881.

Presumably, the statutory "topical or transitory" test was intended to serve as a replacement for a useful life determination. As indicated previously, section 48(k) was enacted in part to eliminate the uncertainty existing under prior law with respect to the determination of useful life. In order to achieve that goal, Congress provided a general rule that permitted taxpayers to claim a two-thirds credit on all qualified films

regardless of useful life. However, Congress apparently determined that inasmuch as other types of qualifying property were not entitled to any credit if their useful lives were less than 3 years, a film or tape, the market for which is primarily topical or transitory in nature, should also be excluded from the benefits of the credit since it reasonably could be expected to have a useful life of less than 3 years. Thus, it is stated in the legislative history that "A taxpayer is not to receive a credit for any films of a transitory or topical nature (because almost all of these films have a useful life of less than three years)." H. Rept. 94–658, *supra*, 1976–3 C.B. (Vol. 2) at 888. Notwithstanding the foregoing, it is clear that Congress did not intend to equate the "topical or transitory" test with a less-than-3-year useful life. The legislative history makes it clear that an otherwise qualifying film is entitled to the ITC even if it has a useful life of less than 3 years. See S. Rept. 94–938, *supra*, 1976–3 C.B. (Vol. 3) at 224; H. Rept. 94–658, *supra*, 1976–3 C.B. (Vol. 2) at 881. Moreover, section 48(k)(1)(A)(i) expressly provides that the determination of whether the credit is allowable with respect to a film or tape is "determined without regard to useful life." We think that a fair reading of the precise statutory language, when coupled with the surrounding legislative history, suggests that Congress intended to deny the ITC to films that reasonably can be expected to become dated very rapidly.

Having reviewed the legislative background leading to the enactment of section 48(k), we turn now to the administrative background leading to the promulgation of the regulation in question. The regulations under section 48(k) were issued in proposed form by notice published in the Federal Register on December 20, 1977.[12] The proposed regulations did not include any reference to game shows, nor did the background information that accompanied the notice issuing the proposed regulations contain any statement with respect to the treatment of game shows. It was only in the final regulations, issued on April 5, 1979, without any further notice of proposed regulations, that the term "game shows" first appeared in the regulations.[13] The background information accompanying the

[12] 42 Fed. Reg. 63791 (1977).
[13] 44 Fed. Reg. 20416 (1979).

final regulations provided as follows with respect to the inclusion of the game show provision:

> The notice of proposed rulemaking provided that variety shows do not qualify for the credit because they deal with personalities of current interest. Several comments were received which suggested that the proposed rule was inappropriate. Nevertheless, examination of the legislative history leads to the conclusion that Congress did not intend that a mere video and sound recording of a *game*, performance, or event would *automatically* qualify for the credit. Accordingly, the proposed rule has been adopted substantially unchanged. [Emphasis added.]

Respondent, in section 1.48–8(a)(3)(iii), Income Tax Regs., attempted to supply the otherwise missing definition of a "film or tape the market for which is primarily topical or is otherwise essentially transitory in nature." He did so by incorporating in the regulations what we will henceforth refer to as the "current interest test." Under the current interest test, "A film or tape is topical or essentially transitory in nature if it primarily deals with events and personalities of current interest at the time the film or tape is placed in service." In addition to supplying a substantive definition of a topical or transitory film, respondent's regulation enumerates examples of such films. One such example, of course, is a game show.[14]

Petitioner's attack on the regulation focuses on both the current interest test and the game show provision. We will focus our analysis on the current interest test before turning to the game show provision.

Petitioner objects to the current interest test on the ground that it focuses on the *format or content* of a film, whereas the statute actually focuses on the *market* of the film. Respondent defends the current interest test by stating that the statutory reference to the *market* of a film does not preclude disqualifying a film on the basis of its format. Indeed, according to respondent, the legislative history specifically indicates that certain types of films or tapes, such as those of sporting events,

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[14] For a more exhaustive discussion of the history underlying the enactment of sec. 48(k) and the promulgation of respondent's accompanying regulations, see Williams, "The Investment Tax Credit In Connection With Record Masters And Motion Pictures—The Only Game In Town," 52 S. Cal. L. Rev. 1121 (1979); Bennett & Forester, "The Investment Tax Credit for Motion Picture and Television Films and Tapes—The Unique and New Rules under the Tax Reform Act of 1976," 1979 S. Cal. Tax Inst. 295.

are to be treated as disqualified films or tapes based on their format and content. It is apparently respondent's position that, if a film primarily deals with events and personalities of current interest, the market for the film is necessarily "primarily topical or otherwise essentially transitory in nature."

For the reasons set forth below, we have concluded that petitioner's TTTT shows did not deal primarily with events and personalities of current interest at the time the tapes were placed in service. Therefore, we need express no opinion with respect to the validity of the regulations' current interest test.

Petitioner's TTTT shows presented durable human interest stories whose audience appeal was as potentially long-lasting as that of many situation comedies or dramatic shows. In other words, the content of TTTT was not such that it would cause the tapes to become rapidly dated as might that of a sporting event or the evening news. The stories told on TTTT concerned, for example, the lives of a professional treasure hunter, the winner of an ugly man contest, a long-distance swimmer, the kennel keeper at the White House, and an expert on and owner of worms, to name just a few. Certainly, these stories would be as interesting today as they were when the shows were produced approximately a decade ago. In other words, the passage of time generally did not affect the original appeal of the subject matter. Thus, the subject matter of TTTT was not limited to events and personalities of current interest. Its subject matter was more general or historical in scope, rather than the recordation of the winner of a sporting event or the announcement of a political happening or the commission of a crime.

In support of his assertion that the subject matter of TTTT was topical in nature, respondent states that the fact that TTTT's staff researched 30 to 50 newspapers a week to locate candidates to appear as real persons, leads to the inevitable conclusion that the real persons possessed certain attributes rendering their stories topical in nature. Further, respondent points out that there were several instances where such real persons also appeared on various news-oriented television shows such as "The Today Show." Respondent asks how, if individuals selected to appear on TTTT as real persons categorically did not possess any attributes rendering their

stories topical in nature, can their appearances on such news-oriented programs be explained.

We think respondent's observations highlight the difficulty of applying the rather slippery and elusive current interest test. We scarcely think that the fact that a particular personality or event may be carried in print or even on a news program a fortiori eliminates the long-lasting appeal of that personality or event. The Court takes judicial notice of the fact that newspapers quite often, and news programs occasionally, cover stories of persons which are of general human interest, regardless of whether those persons can boast of current newsworthy accomplishments. Furthermore, the mere fact that a personality has achieved a currently newsworthy feat does not mean that the interest in that feat is, per se, fleeting.

As a practical matter, since the object of the TTTT show was to try to ascertain which contestant was the real person, the producers of TTTT simply could not use a person who was readily recognizable by the panelists or the viewing public in general. To have done so would have frustrated the very purpose of the show by eliminating the element of suspense. Furthermore, the producers of TTTT did not wish to use stories that involved a contemporaneous news story because audience appeal for a contemporaneous news story would tend to be too short-lived for successful syndication. TTTT shows were taped as many as 4 to 6 months in advance of their first being televised, and preparations for each tape generally had to be commenced a number of months in advance of actual taping. Individual TTTT tapes were thereafter telecast over various television stations at different times, extending over a period of many weeks following the initial telecast. Many of the TTTT tapes were last telecast 2 to 3 years after the particular tapes were made. The extended time required for the preparation, production, distribution, and telecasting of each TTTT tape made it absolutely imperative, as a practical business matter, that the tape present subject matter without restrictive time limitations if the TTTT show was to be successful in syndication. It could not focus upon a celebrity of the moment.

As further support for his contention that petitioner flunks the current interest test, respondent advances the argument that each individual member of the viewing public would be

interested in watching only the initial telecast on a particular station and would not be interested in watching the same show again because the element of surprise no longer would be present. We find respondent's argument unpersuasive and point out that if respondent's argument were accepted as valid, it would lead to the disallowance of the ITC for virtually all types of films or tapes. After all, we suspect that the interest of a viewer in seeing for a second time the same situation comedy or drama has lessened from the first viewing. The current interest test, properly read, must focus on whether a particular film or tape is of sufficiently long-lasting interest that it reasonably may be expected to be rebroadcast over a period of time.

In sum, without expressing any opinion with respect to the validity of the current interest test, we conclude that petitioner's TTTT shows satisfy that test, and we move on to the game show provision.

At the outset, we reject any attempt by petitioner to remove itself from the scope of the game show provision by having us conclude that TTTT was not a game show. TTTT clearly was a game show within the ordinary understanding of that genre of show, albeit with its own unique emphasis and format. The critical question, as we view it, is one of interpreting the scope of the game show provision. Petitioner argues that, if the game show provision imposes a blanket rule that game shows unqualifiedly are not eligible for the ITC, as respondent contends that it does, then the regulation is unjustified and must fall. Alternatively, petitioner urges us to read the game show provision to deny the ITC only to those game shows the markets of which are, *in fact*, primarily topical or otherwise essentially transitory in nature.

Treasury regulations normally are given considerable weight by the courts and should be upheld unless they cannot be interpreted in a fashion consistent with the statutory language they seek to administer or they fail to harmonize with manifest congressional design. *United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 24 (1982); *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948); *Fawcus Machine Co. v. United States*, 282 U.S. 375, 378 (1931); *Lykes Bros. Steamship Co. v. United States*, 513 F.2d 1342, 1350 (Ct. Cl. 1975). Furthermore, "legislative regulations," such as the

regulations issued under section 48, are entitled to even greater weight than regulations issued pursuant to the general authority granted by Congress under section 7805(a). *Fife v. Commissioner*, 82 T.C. 1, 15 (1984). Recognizing the principle that in interpreting a regulation, "the courts should, if possible, avoid a construction which will bring into question" its validity (see *Steen v. Commissioner*, 61 T.C. 298, 304 (1973), affd. per curiam 508 F.2d 268 (5th Cir. 1975), accord, *Dunn v. Commissioner*, 70 T.C. 715, 726 (1978), affd. 615 F.2d 578 (2d Cir., 1980)), we will not presume that respondent intended to lay down an inflexible blanket rule removing game shows unqualifiedly from the category of "qualified films." To so presume would require us to hold the regulation invalid for, if the market of a particular game show is not, in fact, primarily topical or otherwise essentially transitory in nature, the regulation effectively would eliminate the statutory allowance of the ITC to an otherwise qualifying film or tape. The regulation's examples can go no further than the substantive rule that they purport to exemplify.

Respondent argues, in support of his alleged blanket exclusion of game shows from the category of qualified films, that the legislative intent of section 48(k) was to allow the ITC only with respect to films or tapes that embody "lasting, permanent art." According to respondent, a film that embodies the work of script writers, directors, and editors and requires rehearsals and other production processes is regarded as a single, unique asset entitled to the credit; however, typically unrehearsed game shows were not intended to fall within the category of films qualifying for the ITC.

We find nothing in the legislative history, and certainly nothing in the statute, to support respondent's apparent contention that complete scripts and rehearsals were intended to be the touchstones of a qualifying film, and we seriously doubt that Congress intended for respondent to exercise his regulatory authority by assuming the role of an art critic qualified to pass judgment on whether a particular genre of films constitutes "lasting, permanent art." The evidence presented adequately establishes that the development of TTTT shows required a substantial creative effort and a substantial production process that normally entailed a great deal of preparation. The fact that TTTT, because of its nature,

required only limited scripts and rehearsals does not take away from the fact that the filming of TTTT shows required rather substantial preparation and the involvement of a large production staff. In addition, in responding to respondent's legislative intent argument, we must point out that it is crystal clear from the legislative history to section 48(k) that Congress, in adopting that provision, was concerned about promoting domestic employment in the entertainment field.[15] The types of jobs created in producing TTTT (camera persons, stagehands, wardrobe handlers, makeup artists, audio and lighting technicians, etc.) are the types of jobs that Congress surely sought to encourage in adopting the ITC provisions as they relate to movie and television films.

Respondent also argues that failure to read the regulation as imposing a blanket rule with respect to game shows would result in an entirely unworkable situation from an administrative standpoint, in that respondent would be required to engage in the tedious task of reviewing every game show imaginable in an attempt to apply a complicated factual test. We appreciate the burden our interpretation of the game show provision may impose upon respondent. However, in our view, it is a burden that the statute itself imposes on respondent. Respondent cannot eliminate by regulation a credit that the statute otherwise extends. The Supreme Court recently rejected a similar administrative convenience argument raised by respondent in defending a different regulatory provision and, in so doing, stated as follows:

> What the Commissioner cannot do—because it is an "unreasonable" interpretation of the statutory language in light of its history and purpose—is to resolve the practical problems by eliminating the allowance altogether. Eliminating the allowance might make the statute "simpler to administer," * * * but it does so by ignoring the language of the statute, the views of those who sought its enactment, and the purpose they articulated. [*Commissioner v. Engle*, 464 U.S. 206 (1984).]

We hasten to add that we are not herein dealing with a congressional grant of regulatory authority specifically enabling respondent to administer the statute by setting up discrete classifications of films that are not eligible for the ITC

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[15] See, e.g., S. Rept. 94-938 (1976), 1976-3 C.B. (Vol. 3) 224, 227.

or presumptions to that effect, and we should not presume that respondent intended to do so.

We note that a more restrictive interpretation of the scope of the game show provision is fully consistent with respondent's explanation in the preamble to his final regulations that Congress did not intend that a video and sound recording of a game "would automatically" qualify for the credit. That is, respondent's explanation of the provision in no way suggested a blanket rule.

In light of our interpretation of the game show provision, our sole focus at this point should be towards determining whether the market for petitioner's tapes of TTTT shows was in fact primarily topical or otherwise essentially transitory in nature.[16] As we have noted, the statute does not supply a definition of a film or tape whose market is primarily topical or otherwise essentially transitory in nature, and the legislative history merely provides examples without giving a substantive definition. Accordingly, we think it reasonable to assume that Congress intended to use the words chosen in their ordinary, everyday sense. The term "topical" is defined to mean "of or relating to a place"; "local or designed for local application"; "referring to the topics of the day or place"; "of local or temporary interest." Webster's New Collegiate Dictionary 1222 (1979). The term "transitory" is defined to mean "tending to pass away"; "not persistent"; "of brief duration." Webster's New Collegiate Dictionary 1232 (1979). The examples used in the legislative history to illustrate the "topical or transitory" test are consistent with the ordinary, everyday understanding of the statutory language. Those examples (tapes of sports events, the evening news, and

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[16] We recognize that by its terms, respondent's regulation inquires only into the content of a film or tape and not into such factors as actual market potential or history. We have already concluded that petitioner's TTTT shows satisfy respondent's regulatory current interest test; therefore, arguably we need go no further. However, our inquiry into petitioner's market is intended to implement our interpretation of the parameters of the game show provision (i.e., that the provision effectively denies the ITC to a game show whose market is topical or transitory in fact) and to be responsive to respondent's allegation that petitioner's market for the TTTT show was in fact short-lived. Our inquiry into petitioner's market is not intended to be responsive to section 1.48–8(a)(3)(iv), Proposed Income Tax Regs., which appears to provide a second distinct test with regard to whether or not a film or tape placed in service after June 3, 1982, is to be classified as a "qualified film." Whereas the existing regulations focus on the content of a film, the proposed regulations focus on the market of the film. Interestingly enough, the proposed regulations provide that "The market for a film or tape is essentially transitory in nature if, in the normal operation of the particular market for which the film or tape is produced, films or tapes are shown once."

interview shows) possess the common characteristic of becoming dated almost immediately. Moreover, each example given is of a tape or film that deals primarily with events or personalities of uniquely contemporary interest.

Under the facts presented in this case, we are convinced that the market for the TTTT tapes was not "topical" or "transitory" within the ordinary sense of these words. As we have previously stressed, those tapes presented durable human interest stories that were not merely "of local or temporary interest." The audience appeal of those stories was not frozen in locality or time, as might be the case with respect to sporting events, news programs, and interview shows. Therefore, the market for these tapes was not "topical." In addition, the facts reveal that petitioner's tapes were prepared for syndication, that they were first telecast as long as 6 months after they were taped, that individual episodes were rebroadcast time and again over various stations for as long as 3 years after they were taped and produced income during this entire period, that in each season of TTTT shows, licensees were required to show 13 or 17 weeks of reruns, and that a small percentage (1.38 percent) of TTTT shows were rerun by a particular station more than 52 weeks after the initial showing on that particular station. Given these facts and statistics, it is impossible for us to characterize petitioner's market as one "of brief duration." Therefore, the market for those tapes was not "transitory."

Respondent has argued that the fact that a de minimis 1.38 percent of the TTTT shows produced during the years in issue were rerun by a particular station more than 52 weeks after their initial showings overwhelmingly indicates that the market for TTTT shows was essentially transitory. Respondent's argument is premised on entirely too narrow a view of petitioner's market and finds no support in the statute. During the years in issue, TTTT was taped to be syndicated to various television stations throughout the United States. Petitioner's market was clearly not limited to one particular television station. Further, respondent ignores the fact that petitioner's licensee was contractually required to show a number of the productions more than once, a fact inconsistent with the contention of transitory appeal.

In sum, we find the overall restrictive position advanced by respondent in this case to be at odds with the statute and its purpose to encourage investment and domestic employment and with the holdings of this Court, as well as other courts, that the investment credit provisions are to be liberally construed. See, e.g., *Lykes Bros. Steamship Co. v. United States*, 513 F.2d 1342, 1353 (Ct. Cl. 1975); *Minot Federal Savings & Loan Association v. United States*, 435 F.2d 1368, 1372 (8th Cir. 1970); *Northville Dock Corp. v. Commissioner*, 52 T.C. 68, 73 (1969), aff'd. per curiam 427 F.2d 164 (2d Cir. 1970).

In view of the conclusions reached herein, we hold that petitioner is entitled to receive the ITC with respect to its TTTT tapes.[17]

Decision will be entered for the petitioners.

CENTRE FOR INTERNATIONAL UNDERSTANDING, PETITIONER[1] *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

CENTRE FOR INTERNATIONAL UNDERSTANDING, BEATRICE JACOBY, MORTON G. WITZIGREUTER, AND HAROLD B. BAMBURG, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 7520-84X, 7521-84. Filed February 25, 1985.

Held, in these circumstances, consolidation of declaratory judgment case with deficiency case not permitted.

Kent D. Kehr, for the petitioners.
Victoria S. Crosley, for the respondent.

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[17] We commend petitioner, respondent, and amici curiae on the first-rate quality of all briefs submitted in this case.

[1] Hereinafter referred to as the Centre.

OPINION

CANTREL, *Special Trial Judge*: These cases are presently before the Court[2] on petitioners' motion to consolidate filed in each of the above cases on August 6, 1984, pursuant to Rule 141(a).[3] Respondent agrees that these cases be consolidated.

The motion presents an issue of first impression in that it involves consolidating a declaratory judgment case with a case that includes transferee liability and excise and income tax deficiencies determined against the Centre itself and three directors individually. (The latter case, for clarity, will hereinafter be referred to as the deficiency case. Jurisdiction is not an issue in either proceeding.)

The petition in the deficiency case is based upon the issuance on December 27, 1983, of five notices of deficiency and one notice of transferee liability, as follows:

Petitioner	*TYE*	*Deficiency*
Centre	Dec. 31, 1979	$212,334.17
Centre, transferee, of the	Dec. 31, 1976	3,075.57
assets of Colonial Woods	Dec. 31, 1978	2,556.41
Apartments, Co., Transferor	Oct. 16, 1979	189,695.06

		1st Tier (initial deficiency)	*2d Tier (additional deficiency)*
Centre	Dec. 31, 1977	$3,642.01	$29,006.00
	Dec. 31, 1978	4,932.02	30,296.00
	Dec. 31, 1979	10,975.09	86,599.25
Beatrice Jacoby	Dec. 31, 1977	2,334.50	42,346.00
	Dec. 31, 1978	2,280.00	45,496.00
	Dec. 31, 1979	2,525.00	60,496.00
Morton G. Witzigreuter	Dec. 31, 1977	4,346.30	53,842.00
	Dec. 31, 1978	4,004.40	56,992.00
	Dec. 31, 1979	3,962.00	71,992.00
Harold B. Bamburg	Dec. 31, 1977	3,471.30	48,842.00
	Dec. 31, 1978	2,804.40	48,992.00
	Dec. 31, 1979	3,587.00	68,992.00

[2]These cases were assigned pursuant to sec. 7456, Internal Revenue Code of 1954 as amended, and Rules 180 and 181, Tax Court Rules of Practice and Procedure.

[3]All Rule references are to the Tax Court Rules of Practice and Procedure.

The purpose and scope of these actions are very different, so that we must examine the consequences to the parties and this Court if we were to grant the motion. In the declaratory judgment case, the Court will review under the authority of section 7428[4] respondent's final determination that the Centre is not an organization described in section 501(c)(3) and therefore is not exempt from tax under section 501(a). The Centre was initially classified as a private operating foundation under section 4942(j)(3) on February 20, 1972. A trial may be available to the Centre because this is a revocation case. Rule 217; see *Western Catholic Church v. Commissioner*, 73 T.C. 196 (1979), aff'd. without published opinion 631 F.2d 736 (7th Cir. 1980); cf. *Houston Lawyer Referral Service, Inc. v. Commissioner*, 69 T.C. 570 (1978).

The deficiency case involves excise and income tax liabilities determined against the Centre itself and as transferee of the assets of Colonial Woods Apartment Co., a corporation wholly owned by the Centre; along with excise tax deficiencies determined against individual directors of the Centre for the tax years 1977–79. A necessary finding in this case will be whether the Centre was an exempt organization during the years in dispute (1976–79).[5] Once that finding is made, however, other substantial issues will also need to be resolved, including the Centre's tax liability as transferee of assets of a wholly owned corporation, unrelated business income attributable to the Centre, amounts of certain deductions, application of the alternative minimum tax, and self-dealing between the directors and the Centre. Singular disposition of the declaratory judgment case will also leave these other issues to be decided in the deficiency case.

Petitioners argue and respondent concurs that consolidation would be the most efficient way to deal with these two cases,

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[4] All section references are to the Internal Revenue Code of 1954 as amended.

[5] In the statutory notice issued to the Centre for the year 1979, respondent stated that "It is determined that your organization does not qualify for exemption from tax under section 501 of the Internal Revenue Code as set forth in our Final Adverse Determination Letter to you." In the notice of deficiency in excise tax issued to the Centre for the tax years 1977–79, respondent stated, "As a result of the revocation of your exempt status * * * you are subject to section 4940(b) tax." Further, in determining that the Centre had undistributed income for the years 1977–79, respondent stated, "You have failed to meet the exceptions to this tax [imposed by sec. 4942(a)] because (1) you do not meet the qualifications of section 4942(j)(3)." Finally, petitioners attached as Exhibit A to their petition in the deficiency case a copy of the final adverse determination letter respondent sent to the Centre.

which involve some of the same issues of law and fact. The parties also agree that the declaratory judgment case is a revocation case, not a determination with respect to the initial or continuing qualification of an organization as an exempt organization. A trial may be available to the Centre, and the declaratory judgment case need not be submitted solely on the basis of the administrative record. Thus, procedural difficulties from consolidation that would arise in these cases, if one part of the action were limited to a review of the administrative record, are not present. Petitioners further cite as support for their position Rule 215(c), which prohibits joinder of parties in an exempt organization case, but leaves consolidation to be governed by Rule 141. (See also, the last sentence of Rule 210(a).)

Respondent favors consolidation for many of the same reasons as petitioners. Respondent asserts that duplication of evidence will be the result of the declaratory judgment case proceeding prior to the deficiency case, and that evidence dealing with the three directors introduced in the declaratory judgment case will not produce any result binding on them in the deficiency case because they are not parties in the former case.[6] Respondent recognizes, however, that some, but not all, of the issues involving the individual directors of the Centre are similar in both cases. Some of the same general areas of fact and law will be covered in both proceedings, with emphasis on different aspects of these issues.

The question of consolidation rests in the sound discretion of the Court. *Odend'hal v. Commissioner*, 75 T.C. 400, 402 (1980); *Cohen v. Commissioner*, 176 F.2d 394 (10th Cir. 1949). In cases where petitioners are the same, there is a common trial site, the interests of petitioners are not adverse, all petitioners are represented by the same counsel, and where the same issues of fact and law, witnesses, and documentary evidence will be present, then consolidation generally will promote judicial economy and save substantial time and expense for the parties.

In deciding whether to consolidate the particular cases before us, we must look to the purposes and scope of the different actions. The purposes of a declaratory judgment case

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[6] We need not and do not decide here whether respondent's assertion is in fact true (see, e.g., *McQuade v. Commissioner*, 84 T.C. 137 (1985)).

READEX FICHE

pursuant to section 7428 have been set out in the legislative history and in such cases as *New Community Sr. Citizen Housing v. Commissioner*, 72 T.C. 372, 375–376 (1979). In enacting section 7428, Congress showed primary concern that a taxpayer have prompt judicial review of respondent's determination that it is not exempt from tax, either initially or in the situation where respondent revokes a taxpayer's exempt status. Another consideration was to give prompt judicial review for organizations faced with respondent's withdrawal of advance assurances that contributions would be deductible. *New Community Sr. Citizen Housing v. Commissioner*, *supra*.

The Joint Committee report to section 7428 states that declaratory judgment procedures are *not* intended to supplant the normal avenues of judicial review:

> This provision is intended to facilitate relatively prompt judicial review of the specified types of exempt organization issues; it is not intended to supplant the normal avenues of judicial review (redetermination of a deficiency or suit for refund of taxes) where those normal procedures could be expected to provide opportunities for prompt determinations. Consequently, it is expected that the courts will not entertain a declaratory judgment suit with regard to a period for which a notice of deficiency has already been issued, except upon a showing by the organization that the declaratory judgment route is likely to substantially reduce the time necessary to attain a final judicial review of the Service's determination. * * * The Congress' action is not * * * to operate so as to require duplication of effort on the part of parties, witnesses, or courts. [Staff of Joint Comm. on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976, at 404, 1976–3 C.B. (Vol. 2) 416.]

Ordinarily we will not permit consolidation of a declaratory judgment case where a decision is to be made solely on the basis of the administrative record, such as one determining the qualification of an organization as an exempt organization, with a deficiency case because of the difficulties of keeping consideration of the one separate from argument and evidence produced in the deficiency case. That is not a problem, however, in a true revocation case under section 7428, as here, where a trial of the exempt status may be available.

Nevertheless, if we were to consolidate the present cases, they would be set for trial according to the normal calendaring procedures for deficiency cases, and the primary purpose of the declaratory judgment case would be defeated. Nor will consolidation add anything to the deficiency case, because a

necessary finding in the deficiency case will be whether the Centre was an exempt organization for the years at issue.

If we were to allow the declaratory judgment case to proceed first, while staying the deficiency case, the result would be needless duplication of effort by all parties. Moreover, since many issues in the deficiency case would still need to be resolved, hearing the declaratory judgment case first would not significantly reduce the time necessary to attain final judicial review of all the matters in these two cases.

In *Shut Out Dee-Fence, Inc. v. Commissioner*, 77 T.C. 1197, 1202–1204 (1981), a case involving qualification of an employee benefit plan under sections 401 and 501, and wherein the taxpayer, concurrent with filing its declaratory judgment case, sought redetermination of deficiencies in an action that included the same underlying issue, this Court explained that the declaratory judgment procedure is an alternative method, not required to be used, to obtain review of respondent's determination of exempt status, and dismissed the case for lack of jurisdiction. *Shut Out Dee-Fence, Inc. v. Commissioner*, *supra*.

Although here jurisdiction is not an issue in the declaratory judgment case because respondent in fact revoked the Centre's exempt organization status, the Court's comments in *Shut Out Dee-Fence, Inc.* are equally appropriate to our decision. Here, both cases involve the necessary resolution of the issue of whether the Centre is an exempt organization. In this instance, then, because the declaratory judgment procedure is an alternative method of reaching the same result, we do not think it necessary to duplicate the efforts of the parties and the Court by proceeding with the declaratory judgment case first, or at all.

Ordinarily, where a declaratory judgment case is submitted on the administrative record, the case should be decided before final judgment in the deficiency case. Where a trial is available, timing is not such a significant factor for allowing the declaratory judgment case to go forward. Furthermore, because of the problems of consolidating the two types of cases in other situations where a trial in the declaratory judgment case is precluded, we do not wish to encourage consolidation generally of declaratory judgment cases with deficiency cases.

Thus, as to the present situation, the declaratory judgment case is to be stayed until decision is rendered in the deficiency case. Included in such decision will be a decision respecting the Centre's exempt status under section 501. Such decision will necessarily be binding and dispositive of the declaratory judgment case.

An appropriate order will be issued.

RICHARD A. SKRIPAK AND RENEE K. SKRIPAK, ET AL.,[1] PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 745–79, 5914–79, 11391–79, 15040–79, 15667–79, 16214–79, 16215–79, 17479–79, 6101–80, 6178–80, 8009–80. Filed February 26, 1985.

Ps participated in a charitable contributions tax shelter program involving scholarly reprint books. Ps executed a series of documents purporting to evidence the purchase of these reprint books at a cost of one-third of the publisher's catalog retail list prices and the contribution slightly more than 6 months later (the applicable capital gains holding period) of these books to small rural public libraries qualified to receive deductible contributions. Sec. 170(c), I.R.C. 1954. Ps claimed deductions for these "charitable contributions" in the amount of the publisher's catalog retail list prices, i.e., 3 times what they had paid for their "subscriptions" to the book contribution program.

Held: The transaction was not a sham. Ps purchased reprint books and contributed those books to qualified donees and are entitled to charitable contributions deductions for the fair market value of the donated books. Sec. 170, I.R.C. 1954; sec. 1.170A–1(c)(1), Income Tax Regs.

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[1]The cases of the following petitioners have been consolidated: Richard A. Skripak and Renee K. Skripak, docket No. 745–79; William Frank McCall, Jr., docket No. 5914–79; Edgar A. Neely, Jr., and Ruth N. Neely, docket No. 11391–79; Estate of Archer B. Glenn, Jr., Deceased, Wachovia Bank & Trust Co., N.A., Executor, docket No. 15040–79; Thomas S. Wallace and Martha Wallace, docket No. 15667–79; J.W. Lynn, Jr., and Nancy C. Lynn, docket No. 16214–79; Matt B. Russ and Frances R. Russ, docket No. 16215–79; H.C. McDermid and Mary Jo McDermid, docket No. 17479–79; Lovic A. Brooks, Jr., and Carrie Brooks, docket No. 6101–80; W. Henry Maddox and Helen G. Maddox, docket No. 6178–80; and C.H. Smith, docket No. 8009–80.

Held, further, the fair market value of the donated books is no more than 20 percent of the publisher's catalog retail list price (approximately 60 percent of what Ps paid for their subscriptions to the book contribution program), and Ps' charitable contributions deductions are limited to that lower figure.

Charles E. Elrod, Jr., *David G. Phillips*, and *Stephen D. Fromang*, for the petitioners in docket No. 745–79.

Edgar A. Neely, Jr., pro se and for the co-petitioner in docket No. 11391–79.

Charles E. Elrod, Jr., and *David G. Phillips*, for the petitioners in docket Nos. 5914–79, 15040–79, 15667–79, 16214–79, 16215–79, 17479–79, 6101–80, 6178–80, and 8009–80.

Stuart B. Kalb and *Lourdes DeSantis*, for the respondent.

PARKER, *Judge*: Respondent has determined the following deficiencies in these petitioners' Federal income taxes:

Taxpayer(s)	*Docket No.*	*Year(s)*	*Deficiency*
Richard A. Skripak and Renee K. Skripak	745–79	1975	$4,480.30 (increased to $6,820 by amendment to answer)
William Frank McCall, Jr.	5914–79	1975	4,857.00 (increased to $9,846 by amendment to answer)
Edgar A. Neely, Jr., and Ruth N. Neely	11391–79	1975	14,560.54
		1976	16,675.36
Estate of Archer B. Glenn, Jr.	15040–79	1975	42,040.37
Thomas S. Wallace and Martha Wallace	15667–79	1975	16,208.10
J.W. Lynn, Jr., and Nancy C. Lynn	16214–79	1976	7,911.00
Matt B. Russ and Frances R. Russ	16215–79	1975	4,963.93
H.C. McDermid and Mary Jo McDermid	17479–79	1975	11,498.00
		1976	14,785.00
		1977	3,130.00
Lovic A. Brooks, Jr., and Carrie Brooks	6101–80	1975	15,074.00
		1976	7,290.00
W. Henry Maddox and Helen G. Maddox	6178–80	1975	12,371.65
		1976	12,764.74
C.H. Smith	8009–80	1975	23,509.50
		1976	23,140.00

These consolidated cases involve taxpayers who participated in a charitable contributions tax shelter program through which they purportedly purchased scholarly reprint books, held them for slightly more than 6 months, and then contributed them to various small rural public libraries. These taxpayers deducted charitable contributions in amounts of approximately 3 times what they purportedly paid for the books. The issues for decision are whether these taxpayers are entitled to deductions for charitable contributions under section 170,[2] and, if so, the amounts of the allowable deductions.[3]

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The several stipulations of fact and exhibits attached thereto are incorporated herein by this reference.

Petitioner William Frank McCall, Jr. (McCall), docket No. 5914–79, resided in Moultrie, Georgia, at the time he filed his petition in this case. Petitioners Edgar A. Neely, Jr. (Neely), and Ruth N. Neely (collectively the Neelys, docket No. 11391–79), J.W. Lynn, Jr. (Lynn), and Nancy C. Lynn (collectively the Lynns, docket No. 16214–79), and W. Henry Maddox (Maddox) and Helen G. Maddox (collectively the Maddoxes, docket No. 6178–80) all resided in Atlanta, Georgia, at the time they filed their respective petitions in these cases. Petitioners H.C. McDermid (McDermid) and Mary Jo McDermid (collectively the McDermids, docket No. 17479–79) resided in Fort Pierce, Florida, at the time they filed their petition in this case. The Neelys, Lynns, McDermids, and Maddoxes filed their respective joint Federal income tax returns for their years involved, and McCall filed his 1975 individual Federal income tax return, with the Internal Revenue Service Center at Chamblee, Georgia. All of these petitioners used the cash receipts and disbursements method of accounting. When they

[2]Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the taxable years in question, and all references to Rules are to the Tax Court Rules of Practice and Procedure.

[3]The statutory notices in docket Nos. 745–79, 15667–79, 16214–79, 6178–80, and 8009–80 made various adjustments other than the adjustment with respect to charitable contributions. However, petitioners did not challenge these other adjustments in their respective petitions. Accordingly, these other adjustments are deemed to have been conceded. Rule 34(b)(4).

filed their respective petitions, the other petitioners had their residences at the following locations:

Petitioners	*Docket No.*	*Residence*
Richard A. Skripak and Renee K. Skripak	745–79	Fort Pierce, FL
Estate of Archer B. Glenn, Jr., Deceased, Wachovia Bank & Trust Co., N.A., Executor[4]	15040–79	Winston-Salem, NC
Thomas S. Wallace and Martha Wallace	15667–79	Charlotte, NC
Matt B. Russ and Frances R. Russ	16215–79	Mendham, NJ
Lovic A. Brooks, Jr., and Carrie Brooks	6101–80	Atlanta, GA
C.H. Smith	8009–80	Oliver Springs, TN

The cases of McCall, the Lynns, the McDermids, and the Maddoxes have been selected by the parties and tried as the lead cases in these consolidated cases, with the remaining petitioners agreeing to be bound by our determinations in the lead cases.[5] Unless otherwise indicated, the term "petitioners" shall hereinafter refer collectively to McCall, Neely, Lynn, McDermid, and Maddox.

Background of Reprint Publishing and BFL's Sale to Embassy

During the 1960's, the Federal Government began providing large amounts of funds to finance expanding library construction and book acquisitions at American colleges and universities. This created a demand for library books; this demand and a source of funds helped to create a new industry of book publishers, called "reprint publishers." Modern printing technology permitted these publishers to print economically

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[4]Archer B. Glenn, Jr. (Glenn), docket No. 15040–79, died on Aug. 27, 1978. Respondent's statutory notice dated July 30, 1979, was addressed and sent to the Wachovia Bank & Trust Co. (Wachovia), in Winston-Salem, North Carolina, as the executor of Glenn's estate. Wachovia alleged its capacity as the executor, and its situs in North Carolina, but in his answer, respondent denied that portion of the allegation. However, respondent's answer admitted the authenticity of the statutory notice mailed to Wachovia as the executor of the estate. Since then, respondent has not disputed either Wachovia's representative capacity or its North Carolina situs, and accordingly, we consider these facts to be undisputed.

[5]The Neelys (docket No. 11391–79) declined to agree to be bound, so the Court, exercising its discretion, consolidated their case with the four lead cases for purposes of trial, briefing, and opinion.

smaller quantities of books (50 to 150 copies) than book publishers had previously been able to print. These reprint publishers generally selected standard academic works that new and expanding college and university libraries would need to acquire. Generally, the reprint publishers selected titles that were "out of print," meaning that they were no longer available from the original publishers, and older titles that were in the public domain and no longer protected by copyrights. This use of public domain materials meant that the reprint publishers did not have to pay author royalties, and obviated the need to obtain licenses or assignments of existing copyrights. These reprint publishers would do just that—reprint by photo offset or other new techniques titles previously printed by other publishers. These reprint publishers would then sell their reprint books (reprints) to various libraries, primarily college and university libraries, and large public library systems in populous urban areas. During the peak of the library reprint publishing industry, there were more than 300 reprint publishers.

Beginning about 1970, Federal funds were drastically cut, sharply reducing the demand for the academic or scholarly works printed and sold by reprint publishers. Many reprint publishers had not anticipated this cutoff of Federal funds and had printed many more books than the diminished market demanded. Federal funding for academic libraries remained low throughout the 1970's. As a consequence, many reprint publishers went out of business and many others merged with or were acquired by other publishers. By 1981, there remained only a few reprint publishers printing and selling these academic or "scholarly" reprints.

Books For Libraries or BFL Communications, Inc. (BFL), was a book publisher and book manufacturer. BFL published both reprint books and original works (trade publications or trade books). Approximately 70 percent of the reprint titles BFL published were in the public domain, and the remaining 30 percent were published under license by copyright holders on a royalty basis. BFL divided its reprint titles into eight major series, each listed in a separate catalog—(1) Essays, (2) Poetry (Granger Poetry Index), (3) Short Stories, (4) "Selected Bibliographies," (5) American Fiction, (6) Biographies, (7) "Black Heritage Library Collection," and (8) Plays. BFL

normally limited its sales efforts to public libraries located in major metropolitan areas and to college and university libraries. Approximately 70 percent of BFL's customers were colleges, universities, and other institutional libraries. The remaining 30 percent of BFL's customers were book wholesalers or jobbers, most of whom resold the BFL books to the same kinds of institutional libraries. BFL had approximately 7,000 separate reprint titles, and its average reprint inventory during the early 1970's was approximately 1.5 million volumes.

During the early 1970's, BFL leased warehouse space in Hialeah, Florida, where it stored its reprint inventory. The Hialeah warehouse was owned by Ben Fellner (Fellner), who also was a principal owner (if not the sole owner) of Embassy Book Services, Inc. (Embassy). Embassy, formed in 1971 or 1972, had succeeded BFL on a Government contract to supply books to U.S. Information Agency (USIA) libraries overseas.

BFL was affected by the unexpected reduction in Federal library funding for college and university libraries and for public libraries, and, by 1973 BFL was undergoing serious financial difficulties. BFL's inventory of reprint volumes was larger than BFL needed for its regular operations. BFL was under heavy pressure from its creditors to pay some of its debts and decided to sell some of its excess inventory to generate cash from the sale and to write down its inventory and obtain a refund of taxes.

On November 15, 1973, BFL sold 499,351 reprint volumes (sometimes rounded up to 500,000 for convenience) to Embassy for $24,967.55, or 5 cents a book. This agreement between BFL and Embassy prohibited Embassy from selling the reprint books in the United States for 5 years. Embassy did not physically remove the approximately 500,000 books from Fellner's warehouse where they had been stored prior to the sale, but instead merely segregated its books in the warehouse from those belonging to BFL. After its sale to Embassy, BFL still retained over 1 million volumes of books in its inventory, including at least 100 copies of each of the 7,000 reprint titles in its catalogs. Because Embassy's contacts were overseas, and because of the contractual prohibition of domestic sales, BFL's sale to Embassy had no effect on BFL's domestic market for its reprint books.

Joiner and RPI's Book Contribution Program

Thomas E. Joiner (Joiner) is a Georgia attorney. In August and September of 1973, Joiner represented Behavioral Systems, a subsidiary of BFL's corporate parent, Thrift Credit Corp. (Thrift), regarding a possible merger between BFL and Behavioral Systems. Joiner met Harvey Roth, BFL's president, and learned about BFL's financial distress. During the course of this investigation, Joiner learned of the existence of BFL's excess inventory (before the Embassy sale). Joiner was not involved in BFL's November 1973 sale of 500,000 books to Embassy.

Sometime early in 1974, Joiner began investigating a "book contribution plan," under which wealthy or high tax bracket individuals would purchase some of BFL's excess inventory, contribute the books to charitable institutions, and claim tax deductions for those contributions. Joiner contacted a number of libraries in Georgia to ascertain "demand" for free BFL books. After independent research and consultation with an accounting firm, Joiner concluded that taxpayers who purchased and contributed BFL books would be entitled to charitable contribution deductions at BFL's catalog retail list price. Joiner recognized that because the books to be involved in the program were excess inventory, there was a risk of price deterioration and reductions of allowable charitable deductions if BFL's retail list prices decreased during the necessary 6-month holding period. However, Joiner was assured by BFL that it did not intend to sell its books for less than its retail list price. Accordingly, Joiner informed Thrift's president, Burton L. Koffman, that a workable program could be developed. Koffman agreed to let Joiner go ahead with the program and to contact various BFL personnel to work out the details.

In discussing his book contribution plan with Roth, Joiner learned of BFL's November 1973 sale of 500,000 books to Embassy. At some point, Joiner and the BFL representatives agreed that Joiner would acquire some of the books BFL had sold to Embassy. The record does not indicate why BFL chose to have Joiner purchase books from Embassy rather than purchase other books from BFL's own inventory. In any event, Joiner continued to deal primarily with Roth, in part because Roth was acquainted with Fellner, Embassy's principal owner,

but mainly because of the restriction against domestic sale in Embassy's contract with BFL. Joiner viewed it as essential that the books be conveyed free of restrictions, believing that any restriction on disposition could affect the fair market value of the books in the hands of the "contributors." More importantly, BFL's participation was essential for Joiner to acquire the books in the first place—the contract between BFL and Embassy specifically precluded Embassy from selling the books "to any person, firm, corporation or other entity which may resell (or sell to a person who may resell) the Books in the United States."

On June 17, 1974, BFL, Embassy, and Joiner[6] entered into a series of agreements under which—

(1) Joiner obtained an option to purchase from Embassy reprint books with an aggregate retail list price in BFL's catalog of $1.8 million, approximately 150,000 books. The reprint books to which this option pertained were a portion of the 500,000 books BFL had sold to Embassy in 1973. Joiner was entitled to choose from at least 1,000 different titles of which Embassy had at least 20 copies. Joiner was to pay Embassy 25 cents per book for $300,000 worth of books (as determined under BFL's catalog retail list price), approximately the first 25,000 books, and 35 cents per book thereafter. The books to be made available to Joiner were expressly limited to reprint books that BFL was currently selling to college, university, public, and other institutional libraries. This original option as amended extended only for 1 year, but a series of subsequent amendments extended the option until June 30, 1976.

(2) Embassy was obligated to continue to store the books at the Hialeah warehouse until Joiner exercised his purchase option. Embassy agreed to pack and ship the books according to Joiner's instructions when and as Joiner exercised the option. Embassy also agreed, if Joiner so requested, to obtain for Joiner's account insurance on the reprint books subject to Joiner's option in amounts not less than the purchase prices

[6] Although the various transactions involved both Joiner and Francis A. Tarkenton, his business partner, Tarkenton assigned all of his interest to Joiner. Indeed, Tarkenton's assignment was dated June 14, 1974, 3 days *before* the tripartite transaction. In any event, Tarkenton was not involved in the subsequent promotion of the book contribution program. Consequently, we shall treat the June 17, 1974, transactions as between Joiner alone and BFL/Embassy.

(25 cents and 35 cents). Joiner was to reimburse Embassy for the insurance costs when and as he paid Embassy the purchase price, i.e., when and as he exercised his option. Although Embassy was formally obligated to bear all expenses for storage, packing, and shipment of the books, BFL agreed to reimburse Embassy for Embassy's out-of-pocket expenses such as shipping and packing costs.

(3) Joiner was obligated to pay BFL a commission in exchange for BFL's execution of and delivery to Embassy of waivers of the restriction against domestic sales (contained in the original agreement between Embassy and BFL). This commission was 16.67 percent of BFL's catalog retail list price as of the time of sale for the first $300,000 (as determined under BFL's catalog retail list price) worth of Embassy books, and 18.17 percent of BFL's catalog retail list price for the remaining books, *less* the amounts Joiner paid to Embassy (the 25 cents and 35 cents per book). BFL's waiver obligation came into effect only with regard to each specific exercise by Joiner of his option to purchase books from Embassy, and only after Joiner had paid BFL the commission it was due. Joiner also agreed to pay directly to Embassy 20 cents per book out of the commission due BFL as a deposit to cover the shipping and handling expenses for which Embassy was entitled to reimbursement from BFL. Embassy was to return to BFL the reimbursement deposits paid by Joiner on behalf of BFL in excess of Embassy's actual, reimbursable expenses. Since BFL's reimbursements to Embassy of its shipping and handling expenses were paid out of Joiner's commission to BFL, Joiner effectively bore the costs of shipping and handling. Consequently, Joiner's total cost for the reprint books was 16.67 and 18.17 percent per book of BFL's catalog retail list price.

Also on June 17, 1974, Joiner assigned his interest in these contracts to Reprints, Inc. (RPI), a Georgia corporation formed shortly before these transactions. Joiner was RPI's president and sole shareholder.

RPI put together a "Book Purchase Participation Program" (book contribution program) by which it identified libraries to receive books and contributors who would purportedly purchase the books from RPI and contribute them to the libraries. Although Neely participated in RPI's 1974 book contribution

program, none of the deficiencies determined against the Neelys or against the other taxpayers in these consolidated cases involved RPI's 1974 program. Aside from the number and identities of the participants and certain mechanical aspects of matching participants and libraries, RPI's 1974 program was essentially the same as its 1975 and 1976 contribution programs. We shall not make separate findings regarding RPI's 1974 program.

RPI's first step was to put together a list of BFL reprint titles that would be made available to participating libraries. Accordingly, BFL's president selected[7] various titles from BFL's catalogs, titles of which Embassy had adequate quantities (at least 20 copies), to be offered to libraries.

Next, Joiner, on behalf of RPI, sent out form letters to various small institutional and rural public libraries informing them of the program. These letters stated that books were to be given to libraries by various "interested donors," books that "nonurban libraries, * * * due to budgetary limitations, may not be able to provide." A library's obligation under the plan was "to accept the donation, to acknowledge receipt of the donation when delivered and to certify that the books are accepted for use in the Libraries." The books were to be delivered to the libraries at no cost (e.g., no shipping charges), but the participating libraries were required "to bear whatever expense would be involved in processing the books for use in the Libraries" once the books were received by the libraries. Each solicitation included lists of the BFL reprint titles available to the libraries that chose to participate in RPI's book contribution program. These lists were separated into series of books corresponding with BFL's various series as of the time of BFL's 1973 sale to Embassy. RPI used the BFL series titles—(1) Granger (Poetry), (2) Essay, (3) Short Stories, (4) Selected Bibliographies, and (5) Black Heritage. It is not clear whether BFL's other three series—American Fiction, Biographies, and Plays—were offered under RPI's program.

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[7] Joiner testified that Roth selected the titles, but Roth denied that he did so. Since RPI was concerned that the titles to be offered were still being offered and sold by BFL (in order to document RPI's position on fair market value), and since Roth was more familiar than either Fellner or Joiner with the BFL titles owned by Embassy and with the titles still being sold by BFL, it appears more likely that Roth selected the titles, and we so find as a fact.

For the years 1975 and 1976, the RPI book contribution programs included approximately 3,023 different reprint titles. RPI offered approximately 2,678 separate BFL reprint titles in its 1975 program (part I and part II). RPI offered approximately 1,240 BFL reprint titles in its 1976 program, of which approximately 895 had also been offered under the 1975 program and 345 were new titles for that year. The libraries were asked to select from these lists the titles and the number of copies of each they wished to receive. At some point in this preliminary step, RPI asked each participating library to certify its status as a tax-exempt institution entitled to receive deductible charitable contributions.

RPI's solicitations were primarily, if not exclusively, to small rural public libraries in the southeastern United States. Such libraries normally purchased few, if any, reprint books from BFL, and such reprint books as they purchased normally involved geneology or local history subjects of a type not included in the RPI book contribution program. Consequently, RPI's book contribution program had virtually no effect upon BFL's market. Although Roth and BFL knew of RPI's book contribution plan when BFL agreed to its portion of the June 17, 1974, transactions, there was no express agreement or understanding that Joiner (through RPI) would not solicit libraries in BFL's market. In fact, a few of the books channeled through RPI's program ended up with some of BFL's primary customers such as the University of South Carolina. However, Joiner largely limited his solicitations for RPI to the small, rural libraries, and the vast majority of RPI's books ended up in the hands of these libraries.

Not surprisingly, many libraries chose to participate in RPI's book contribution program by filling out the lists of selected titles and certifying their tax exemptions. Generally, libraries, particularly small rural public libraries of the type solicited by RPI, have difficulty rejecting any gifts of books because of the bad public relations problems that would develop with their patrons and governing public bodies if it became known that they rejected free books. In 1975 and 1976, RPI used a computer to keep track of most of the participating libraries' selections.[6]

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[6] In 1974, this had been done manually. RPI's computer list for its 1975 program inexplicably omitted approximately 100 titles, most of which were multiple volume sets. However, the parties

RPI's next step was to locate "donors" to "purchase" the books to be contributed to the participating libraries. In 1975 and 1976, RPI prepared and circulated offering memoranda, describing the program as follows:

> Under this Program, a Purchaser will buy Units of Books. It is anticipated that he will hold the Books for more than six months and then make a gift of them to a qualified organization, such that the fair market value of the Books at the time of gift will be deductible for federal income tax purposes. * * * It is anticipated that such fair market value will far exceed the purchaser's cost in the Books so that the Purchaser will receive a net tax benefit from the Program.
>
> * * * * * * *
>
> [RPI] intends to purchase volumes under the Embassy Option and then resell them under the Program at ⅓ of the BFL catalogue list price. Under the Program, separate lots of books will be sold outright to purchasers so that purchasers will acquire unrestricted ownership of particular books allocated to them. The books will be at the complete will and disposition of the Purchaser, who may have them delivered to his home or to any place specified by him.

Under the program, a purchaser would have no out-of-pocket expenses for storage, insurance, shipping, and the like—(1) there were no storage charges for the books at the warehouse in Hialeah, Florida; (2) RPI would obtain and deliver to the purchaser insurance binders showing full coverage in the purchaser's name in the amount of the purchaser's cost of his books; and (3) Embassy was to bear the cost of shipping the books to the contemplated donees, or to wherever the purchaser designated the books to be sent.

With regard to eventual disposition of the books, the offering memoranda stated—

> a Purchaser is free to dispose of books purchased by him at any time, in any manner and to any person or entity selected by him. However, the Program is predicated on the theory that Purchasers will use the books for the support of institutions in need by donating them to Qualified Organizations, as defined herein. To aid Purchasers in the disposition of the books, [RPI] will compile a list of Qualified Organizations which express a willingness and desire to have books of a certain type donated to them. Upon authorization of a Purchaser pursuant to the Request for Instructions mentioned above, [RPI] will arrange for and execute donations on behalf of

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and the Court have included these titles in their count of the number of titles involved in the book contribution program.

such Purchaser. A portion of the proceeds from the Program received by [RPI] will be used for this administrative function.

Although hedged, the memoranda contemplated that the participants would claim charitable contributions valuing their contributed books at BFL's catalog retail list price, 3 times what the taxpayer-purchasers would pay to RPI. RPI's book contribution program was aimed at high-bracket taxpayers who could best benefit from charitable contributions deductions.

The offering memoranda warned that the purchase of the units of books involved a high degree of risk. Among the reasons stated in the memoranda for this high risk were—(1) the recent incorporation and minimal assets of both RPI and Embassy; (2) BFL's continuing financial decline and uncertain market; (3) the improbability of profitable resale of the books by the RPI purchasers because they had no experience in the market; (4) the possible challenge of the tax treatment by IRS; (5) the absence of commitments from libraries for all books available under program, with the risk that RPI might not be able to arrange contributions for everyone desiring to have RPI do so; (6) possible error by RPI in determining tax-exempt status of certain donees; and (7) possible change in Federal tax laws.

Although Joiner and RPI's counsel did not believe that its book contribution subscription agreement constituted securities within the meaning of Federal and State securities laws, nonetheless, RPI's program was offered and sold under the "private offering" exception from registration available under Federal securities law. For this reason, RPI used formal offering memoranda and used terms such as "units of participation" and the like. For the same reason, RPI's offering memoranda required each potential purchaser to complete a "preliminary questionnaire" to confirm the participant's financial status and awareness of the nature and risks of RPI's book contribution program. Likewise, each participant was required to execute a subscription agreement—(1) acknowledging receipt of the offering memorandum and agreeing that his purchase was to be governed by the terms of the memorandum; (2) confirming his execution of the preliminary questionnaire, affirming the truth of statements therein, and authorizing reliance thereupon by RPI; (3) acknowledging that the

opportunity was offered to him to examine fully all aspects of the offering and to ask and have answered by RPI personnel questions regarding the program; (4) representing his financial savvy or reliance upon advice sufficient to evaluate the merits and risks of the program, and representing his ability to bear the economic risks of the program; and (5) acknowledging that the memorandum was the sole means of offer and that no general public solicitation occurred.

The 1975 memorandum offered 200-book units at $2,500 per unit. The minimum purchase was four units, although the memorandum allowed a purchaser to buy one-half immediately (part I of the 1975 program) and to contract to buy the remaining one-half at a later date (part II of the 1975 program). For part I, the memorandum called for consummation of the purchase on or about June 25, 1975, so that the 6-month holding period could be met for 1975. For part II, the purchase was to be consummated on or about February 1, 1976.

The 1976 memorandum offered 64-book units at $2,500 per unit. The minimum purchase was two units. The memorandum called for consummation of the purchase by June 30, 1976, so that the 6-month holding period could be met for 1976.

RPI's book contribution program was successfully marketed. Approximately 40 individuals subscribed, many of whom purchased participation units in more than 1 year. When an individual subscribed to the 1975 or 1976 program (either through a firm oral commitment or submission of the written subscription form), the subscription information (name and amount of subscription) would be keypunched and entered into the computer. In most cases, the computer would allocate to each participant a list or lists of books that RPI had previously allocated to a particular library pursuant to its selection list. Towards the end of the 1976 program, when RPI was running out of libraries, certain books were allocated to participants that had not yet been allocated to or selected by libraries. RPI subsequently located libraries that would accept the books previously allocated to these purchasers. With one exception, these were the only occasions where the participating libraries were not given the opportunity to select the books they wished to receive but instead were merely presented a list of books to accept or reject.

The computer was programmed to match a sufficient number of library selections with a purchaser so that the BFL catalog list prices of the selections totaled approximately 3 times the amount of the purchaser's subscription. In other words, each $2,500 participation unit was thus allocated books with list prices in BFL's retail catalog aggregating approximately $7,500. At this point, the computer printed out separately numbered lists showing each set of books allocated to one purchaser and one library.

Next, RPI prepared a document entitled "Warehouse Receipt" for each numbered computer book list, stating as follows:

WAREHOUSE RECEIPT

Embassy Book Service, Inc.
5301 N.W. 161 Street
Hialeah Lake, FL 33014

Consecutive No. L- _____

Date of Issue: June _____, 1975

THIS IS TO CERTIFY that Embassy Book Service, Inc. ("Embassy") received in the warehouse situated at 5301 N.W. 161 Street, Hialeah Lake, Florida 33014 for the account of [RPI] ("Depositor") in apparent good order, except as noted hereon (contents, condition and quality unknown) the order of books containing _____ volumes packaged in boxes bearing the designation L- _____ and being those books specified on the schedule designated as LIST NB. L- _____ which is annexed to Bill of Sale No. RL _____ of even date herewith by and between Embassy Book Service, Inc. and [RPI] and Bill of Sale No. PL _____ of even date herewith by and between [RPI] and _____, which schedule is incorporated by reference as a part of this receipt, subject to all the terms and conditions contained in the existing contractual agreements between Embassy Book Service, Inc. and [RPI] with regard to said books, such property to be delivered to Depositor's order, upon the surrender of this Warehouse Receipt properly endorsed.

EMBASSY BOOK SERVICE, INC.

By: _____
President

FIRST ENDORSEMENT

All right, title and interest in this receipt and the goods covered hereby is hereby endorsed and assigned to _____ to whom the goods covered hereby have been sold.

[RPI]

By: _____
President

Dated: June ____, 1975

SECOND ENDORSEMENT

The books described in the above Warehouse Receipt are hereby released from this receipt for delivery from Warehouse.

This ____ day of _____, 197 ____.

_____
Assignee of Depositor

RPI exercised its purchase option and received bills of sale from Embassy containing the same computer book lists. Fellner signed each "Warehouse Receipt" on behalf of Embassy.

RPI prepared a document entitled "Bill of Sale" for each matched "Warehouse Receipt" and numbered book list, stating as follows:

Consecutive No. PL _____

BILL OF SALE

KNOW ALL MEN BY THESE PRESENTS that [RPI], in consideration of ten dollars ($10) and other good and valuable consideration paid to it by _____ ("Purchaser"), the receipt whereof is hereby acknowledged, does hereby sell, assign and deliver to the said Purchaser the goods, chattels and personal property enumerated and described in the schedule hereto annexed and designated as LIST NB. L- ____. To hold the same to the said Purchaser for his own use and benefit. Title to said goods, chattels and personal property passes from Seller to the Purchaser at the time the Bill of Sale is placed in the U.S. Mail addressed to Purchaser.

Joiner, on behalf of RPI, signed each "Bill of Sale" and the assignment space on each "Warehouse Receipt," and filled in the appropriate spaces with the list number or numbers, the participant's name, and the date. The respective computer list

numbers, warehouse receipt numbers, and bill of sale numbers all matched.

In addition to each "Bill of Sale" and "Warehouse Receipt," RPI sent to each participant a letter stating in part:

ACCEPTANCE OF SUBSCRIPTION

This is to inform you that your subscription for the Book Purchase Participation Program of [RPI] has been accepted. Enclosed herewith are Bill of Sale No. PL _____ which transfer title to the books listed on the attached schedules to you. There will be forwarded to you under separate cover and without a cover letter a Warehouse Receipt. YOU MUST RETAIN THE ORIGINAL OF THIS WAREHOUSE RECEIPT AND RETURN, PROPERLY ENDORSED, IN ORDER TO OBTAIN A RELEASE OF YOUR BOOKS FROM THE WAREHOUSE.

On each letter, the blank space was filled in with the appropriate "Bill of Sale" numbers.

At the same time these documents were prepared and sent, the books allocated to each participant were segregated by their respective computer book lists and set aside for each participant at Fellner's warehouse in Hialeah, Florida.

In November of 1975, RPI, through Joiner, contacted the book contribution program participants, sending each participant a letter entitled "Consummation of Donation," a form entitled "Request for Instructions," and a document or documents entitled "Special Power of Attorney." The "Consummation of Donation" letter stated that the time had arrived to arrange to close out the book program on December 29, 1975. The letter asked each participant to complete the "Request for Instructions" form so that RPI would know what each participant wanted done with the books allocated to him. The letter directed the participants to sign the second endorsement on their respective warehouse receipts, post-dating their assignments to December 29, 1975.[9] If the participant wanted RPI to arrange the "donation" of the participant's books, he was instructed to sign and to check the appropriate box on the

[9] Indeed, the letters directed certain participants to "correct" certain dating errors, stating—

"Some of you have already returned the Warehouse Receipts with the date left blank. The date December 29, 1975 will be inserted on these Warehouse Receipts. Others of you have returned the Warehouse Receipts with dates other than December 29, 1975 inserted. Those Warehouse Receipts are returned herewith with the dates changed to December 29, 1975. Those of you who receive such Warehouse Receipts with this communication should initial each Warehouse Receipt above both the number "29" and the month "December" at the places where the changes are made."

"Request for Instructions" form and to complete the "Special Power of Attorney" form or forms. These "Special Power of Attorney" documents stated that the participant authorized Joiner, as the participant's "Attorney in Fact," to donate the participant's allocated books to a designated library. There was a separate "Special Power of Attorney" form for each participating library and participating "donor," each form separately identifying the RPI computer book list number used in the "Bill of Sale" and "Warehouse Receipt" documents. Each library designated on each "Special Power of Attorney" form was the library to which the RPI computer had allocated the titles on the computer book list at the time the participant had subscribed to the program.

If a participant did not want RPI to arrange to donate the books allocated to him, he was instructed to execute and postdate the second assignment on the "Warehouse Receipt" document, to sign and to check the appropriate box on the "Request for Instructions" form, and to indicate on the "Request for Instructions" form where he wanted the books to be shipped. A few RPI participants specifically designated the institutions that would receive the books allocated to those participants. Most participants, however, chose to have RPI arrange the donations, executing the appropriate "Special Power of Attorney" forms.

After confirming what the participants wanted done with the books allocated to them, RPI again contacted the libraries that had chosen to participate in RPI's book program by selecting titles they wanted to receive. Most of these libraries still wanted the books. In the few instances where the libraries decided not to accept books, RPI located other libraries that were interested in and willing to accept the books. These libraries were not given the opportunity to select the titles they wanted to receive but instead were offered those books previously allocated to another library (and specifically allocated to a particular participant) to accept or reject.

RPI instructed each library still wishing to receive books to execute a form or forms entitled "Special Power of Attorney." Each form stated that the library designated Joiner as the library's "Attorney in Fact," empowered on its behalf to accept and execute acceptance forms for the books to be transferred

to the library. Each recipient library executed these "Special Power of Attorney" forms.

Next, Joiner executed a dual document for each participant and designated library. The top half of each such document, captioned "Declaration of Gift," stated that Joiner on behalf of the participant was giving books, identified by reference to an attached list (the RPI computer book list), to the designated library. The bottom half of the document, captioned "Acceptance of Gift," stated that Joiner, on behalf of the designated library, accepted the gift of books. Both halves of the documents were dated December 29, 1975.

Joiner directed Embassy to ship each participant's allocated books to the designated library or libraries. Subsequently, the libraries executed forms prepared by RPI acknowledging their receipt of the books. Generally, these "Acknowledgement of Receipt" forms were dated in February of 1976. RPI then prepared and sent to its participants documents entitled "STATEMENT OF INFORMATION REQUIRED BY SECTION 1.170–1(a)(3)(ii)"[10] (section 170 statements), which provided as follows:

> The information set forth below relates to the deduction in the amount of ____ under the contribution section of Taxpayer's Itemized Deductions.
>
> (a) The name and address of the organization(s) as to which the contribution was made is:
>
> (b) The date of the actual contribution was: _____
>
> (c) The property contributed was new library books which were in excellent physical condition at the time of the contribution.
>
> (d) The property was acquired by purchase and the date of acquisition was _____
>
> (e) The fair market value of the property at the time the contribution was made was the amount of _____ and the method utilized in determining the fair market value was the published catalogue price for sales to libraries by the publisher of the books.
>
> (f) The cost of said property was _____ or approximately 150 percent of manufacturing cost and taxpayer has taken no deductions relating to said property under the provisions of Section 1016 of the Internal Revenue Code.
>
> (g) No deduction was taken into account by reason of Section 170(e) of the Internal Revenue Code because no deduction is required.
>
> (h) Taxpayer entered into no agreement or understanding relating to the use, sale, or disposition of the property contributed except that the contribution was made on the good faith representation that the donee accepted the gift with the intent to use the books in the library of donee.

[10] The appropriate reference is actually sec. 1.170A–1(a)(2)(ii), Income Tax Regs.

(i) 100 percent of the amount stated in subparagraph (e) was claimed as a deduction for the taxable year ____ and the entire interest in the property was contributed during the taxable year of ____. No deductions have been claimed in any prior year or years as to interest in the property contributed.

RPI supplied the pertinent information in these blank spaces for the taxpayers.

Both Part II of RPI's 1975 program (the "purchases" postponed to February 1, 1976) and its 1976 program used the same series of transactions and forms, including computer matching of "donor" participants with "donee" libraries, "Warehouse Receipts," "Bills of Sale," and "Special Powers of Attorney" to Joiner for both "donor" and "donee." The goal of each series of transactions and forms was to give each participant legal ownership and control of certain books for slightly over 6 months, and to arrange donations of those books to "qualified" (e.g., tax-exempt) libraries and institutions so that each participant would be deemed the "donor" to the recipient libraries of those books.

None of the RPI participants ever sold his allocated books on the open market, nor did any participant elect to keep his allocated books for his own use. All of the RPI participants "chose" to "contribute" their allocated books to various public libraries as contemplated under RPI's book contribution program.

The offering memoranda indicated that after payment of its acquisition costs and other costs and expenses in the program, RPI would net about 20 percent of the total amounts of the participants' subscriptions as its profit from the programs. This would be about $2,000 of each $10,000 subscription price, but the record does not indicate the actual profit realized by RPI on the book contribution program.

Petitioners' Participation in RPI's Book Contribution Program

Each of the petitioners (McCall, Neely, Lynn, McDermid, and Maddox) purchased units of participation in RPI's book contribution program. Each petitioner was approximately in the 50-percent marginal rate tax bracket at the time. Lynn subscribed to RPI's 1976 program, while the others subscribed to both part I and part II of RPI's 1975 program.

Each of the petitioners received an offering memorandum and completed a preliminary questionnaire and subscription agreement. Each of the petitioners received from RPI "Acceptance of Subscription," "Bill of Sale," and "Warehouse Receipt" documents referring to specific RPI numbered computer book lists.[11] None of the "Bill of Sale" documents sent to McDermid were signed on behalf of RPI. The remaining documents, including all of the "Warehouse Receipt" documents, were signed by Joiner on RPI's behalf. Each of these computer book lists represented books already allocated to a specific library that had chosen to participate, the allocation based on the specific titles each library had asked to receive.

The four petitioners who participated in RPI's 1975 program (McCall, Neely, McDermid, and Maddox) were collectively allocated a copy or copies of 2,645 of the 2,678 BFL reprint titles available in the RPI program, or 98.8 percent. Of those 2,645 titles so allocated, 264 (10 percent) were allocated to only one of the four petitioners, 1,126 titles (42.6 percent) to two, 887 titles (33.5 percent) to three, and 368 (13.9 percent) to all four. Including the 1975 titles offered under RPI's 1976 program that were allocated to Lynn (a participant in the 1976 program), an average of 5.5 copies per title were allocated to the lead petitioners.

Lynn, the only lead petitioner who participated in RPI's 1976 program, was allocated 225 of the 345 BFL reprint titles (65.2 percent) offered exclusively under RPI's 1976 program. Lynn was allocated an average of 2.4 copies per title of these 225 titles.

Some of the petitioners investigated the possibility of having their allocated books transferred to institutions other than those already lined up by RPI. However, with one exception,[12]

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[11]Under part I of the 1975 program, the "Acceptance of Subscription," "Bill of Sale," and "Warehouse Receipt" documents were dated between June 18, 1975, and June 26, 1975. Under part II of the 1975 program, these documents were dated Feb. 28, 1976, and Mar. 1, 1976. Lynn's documents in the 1976 program were dated June 26, 1976, and June 28, 1976.

[12]In connection with his subscription to part I of RPI's 1975 program, Maddox considered donating his allocated books to the Mt. Vernon Christian Academy (Mt. Vernon) in Atlanta, a private school that his children attended. Ultimately, he chose not to contribute to the school because it had been open for only a short time and he had some concern over its tax-exempt status. With respect to his subscription for part II of RPI's 1975 program, Maddox arranged with RPI for Mt. Vernon to select titles to receive. RPI allocated those titles to Maddox and Maddox directed that the books be donated to Mt. Vernon, executing a "Special Power of Attorney" form authorizing Joiner to transfer the books to Mt. Vernon. Mt. Vernon likewise executed a typical RPI "Special Power of Attorney" form stating that Joiner was its "Attorney in Fact" to accept the "donation."

each of the petitioners chose to have RPI arrange the donations of his allocated books and executed the "Special Power of Attorney" forms.[13] Each participating library selecting to receive each petitioner's allocated books likewise executed its respective "Special Power of Attorney" form. With respect to each corresponding petitioner and participating library, Joiner executed the appropriate "Declaration of Gift" and "Acknowledgement of Gift" forms in his purported dual capacity as "Attorney in Fact" for both the petitioner and the library.[14] Each library subsequently executed "Acknowledgement of Receipt" forms. Each library actually received the books so designated, books that, with one exception, each had selected to receive.[15] Each recipient library was a charitable organization under section 170(c) at the times the transfers of books to each occurred. Each petitioner received his respective section 170 statement prepared by RPI.

The petitioners never had physical possession of the books allocated to them. Except for Maddox, none of the petitioners ever saw their allocated books; Maddox saw the books he had directed be given to Mt. Vernon sometime after the transfer. Except for Maddox' connection with Mt. Vernon, by and large, none of the petitioners had ever donated books to, visited, or heard of the recipient libraries.

Each of the petitioners believed that he had the unrestricted right to deal with the books in whatever manner he chose. None of the various documents involved placed any restrictions on the rights of any participants to deal with the books, including their rights to sell them, to take possession of them, or to transfer them to any person or entity of their choice. There is no evidence that RPI ever treated or disposed of any participant's books in any manner different from or other than as "instructed" by the participant.

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[13] Under part I of the 1975 program, petitioners' signatures on the "Request for Instructions" and "Special Power of Attorney" forms were dated between Nov. 21, 1975, and Nov. 29, 1975. Under part II of the 1975 program, these documents were dated between Oct. 6, 1976, and Nov. 2, 1976. Lynn's documents under the 1976 program were dated Dec. 15, 1976, and Dec. 30, 1976.

[14] Under part I of the 1975 program, these documents were dated Dec. 30, 1975. Under part II of the 1975 program, these documents were dated between Oct. 29, 1976, and Nov. 17, 1976. Lynn's documents under the 1976 program were dated Dec. 30, 1976.

[15] In connection with the books allocated to Neely under part II of the 1975 program, the initial library backed out. RPI searched for and found another library to accept the specific titles already allocated to Neely. Neely had to execute another "Special Power of Attorney" form.

Valuation of the Subject Reprint Books

Content

The various BFL reprint titles involved in RPI's book contribution program consisted largely of anthologies of poems, short stories, essays, certain biographies, a collection of works on Black History, and various other fairly obscure works of relatively well-known authors. Such works are primarily needed in libraries where major research is conducted, such as university and college libraries and public libraries in large urban areas. Such works are generally beyond the research needs of the general public or public school students who patronize the smaller rural public libraries that received these books under RPI's book contribution program. Generally, such works in the collections of these small rural libraries are used relatively infrequently.

Use of the RPI Books by the Recipient Libraries

Generally, the patrons of small rural public libraries such as those which received these books are interested in best sellers and current fiction and nonfiction, and purchases of scholarly reprint books are a rather low priority item for such libraries. The reactions of the various libraries when they received the BFL reprint books were mixed. Some of the libraries were generally pleased with the books they received and proceeded to catalog, shelve, and circulate the books. Others were less satisfied, discovering the nature of the books (college level research materials) for the first time upon receiving the books.

Also many of these small rural public libraries did not have the necessary indices or "finding tools" to enable their patrons to make effective use of those scholarly reprint books. Many of these libraries disposed of large numbers of these reprint books through donations to others institutions or through "flea market" sales at 25 to 50 cents per book. One librarian threw away virtually every book his library had received under the RPI program.[16]

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[16]This librarian was not the one who had selected the books for the library to receive under RPI's solicitation, and he had a different view of the library's function and acquisition policy from that of the librarian who had selected the books. This was the case with several of the recipient libraries, and may explain some of the negative reaction to the books.

Sales by BFL

The RPI book contribution program included slightly more than 3,000 (3,023) of BFL's 7,000 titles. From 1974 through 1976, while RPI was operating its book contribution program, BFL continued to offer for sale its own inventory of its reprint books at its catalog retail list prices.

In 1975 and 1976, BFL sold at least four copies of every one of its reprint titles that were in the RPI program (except for its poetry series) to the Miami - Dade County Public Library System. In 1975, BFL sold a copy of every title in three of its catalogs in the RPI program (essay, short story, and poetry) to the library at the Evergreen State College in Olympia, Washington. In both cases, the libraries paid BFL's full catalog retail list prices. In both cases, the acquisitions-librarians had substantial funds available, appropriated funds that had to be spent by the end of the fiscal year or that would be restored to the budgetary authority supervising those libraries. Those two sales were atypical of BFL's business during the years before the Court. Those two sales harkened back to the big-budget, free-spending days of the 1960's, which helped to create the reprint publishing industry, and did not reflect the actual market realities of that industry by the years in question.

During these years, BFL's institutional library customers normally paid BFL's catalog retail list price, while its wholesale customers (book jobbers) paid approximately 90 percent of BFL's catalog retail list price. BFL's sales records for the year indicate the following:

	Including Miami-Dade and Evergreen sales	*Excluding Miami-Dade and Evergreen sales*
Number of RPI titles as percentage of BFL sales of all titles	44.6% (14,284 out of 32,007)	19.3% (483 out of 2,505)
Percentage of titles offered under RPI's 1975 program (including RPI's 1975 titles also offered in its 1976 program) sold by BFL during the years 1975–76.....	100%	15.0%

	Including Miami-Dade and Evergreen sales	*Excluding Miami-Dade and Evergreen sales*
Percentage of titles offered exclusively under RPI's 1976 program sold by BFL during the years 1975–76	100%	13.3%
Average number of copies per title of titles offered under RPI's 1975 program (including RPI's 1975 titles also offered in its 1976 program) sold by BFL during the years 1975–76	4.72%	0.16%
Average number of copies per title of titles offered exclusively under RPI's 1976 program sold by BFL during the years 1975–76	4.79%	0.145%

BFL sold 32,007 reprint books in 1975 and 1976. Of the documented BFL sales in 1975 and 1976, slightly more than 80 percent of those BFL sales were sales of titles *not* included in the RPI book contribution program and slightly less than 20 percent (19.3) were sales of the same titles (excluding the Miami-Dade and Evergreen sales). Including the Miami-Dade and Evergreen sales, 44.6 percent of BFL's sales were sales of the same titles as those offered in the RPI program and slightly over 55 percent of the BFL sales were sales of titles *not* offered in RPI's program.

Considering only BFL's sales of the same reprint titles offered in the RPI book contribution program, BFL's sales included only 15.0 and 13.3 percent (excluding the Miami-Dade and Evergreen sales) of the total number of titles offered in the RPI program. In other words, BFL's actual sales of the RPI titles were negligible if the Miami-Dade and Evergreen sales are excluded.

Approximately 150,000 BFL reprint books were involved in the RPI book contribution program. In 1977, after RPI wound up its program, BFL repurchased the remaining reprint books from Embassy, approximately 350,000 books, paying 35 cents per book. BFL then resold these books, and its remaining reprint inventory to Arno Press (Arno), another reprint

publisher and seller, for approximately 53 cents per book.[17] Arno continued to offer for sale the BFL reprint titles at prices comparable to these in BFL's retail catalogs.

Sales in the "Antiquarian" (Second-Hand) Book Market

The "antiquarian," out-of-print, or second-hand book market involves rare, used, or out-of-print (no longer available from original publisher) books. The connection between the antiquarian book industry and the reprint publishing industry is somewhat remote and nebulous. Some of the early reprint publishers were second-hand book dealers, and many of the titles first chosen for reprinting were titles that were very popular in the second-hand market. Prices for antiquarian or out-of-print books reflect various elements, including collectibility (rarity and condition) and informational content. In some instances, market prices for antiquarian, out-of-print, or second-hand books may be relevant in determining the fair market value of some of the BFL reprint books, but only to the extent that the informational content element of a particular reprint title can be segregated from the elements of the market price representing collectibility factors. Generally, however, the market prices for antiquarian, out-of-print, or second-hand books are not relevant to the fair market value of BFL reprint books. The BFL reprint books were neither rare nor used, and they were not out of print in the sense that they were readily available from BFL.

Treatment by Petitioners on Their Returns

Each of the lead petitioners claimed deductions on his respective returns for charitable contributions of books to various libraries, as follows:

Taxpayer	*Year*	*Cost*	*Claimed value of contribution*	*Amount of deduction claimed*
McCall	1975	$10,000	$30,005.50	$20,066.00
Neely	1975	10,000	30,009.25	30,009.25
Neely	1976	10,000	30,106.00	30,106.00
Lynn	1976	5,000	15,007.75	15,008.00
McDermid	1975	10,000	29,953.00	29,953.00

[17] BFL was also entitled to a royalty of 8 percent of revenues in excess of $2.5 million for the period between the Arno sale and April of 1982.

Taxpayer	*Year*	*Cost*	*Claimed value of contribution*	*Amount of deduction claimed*
McDermid	1976	$10,000	$30,138.75	$28,400.00
Maddox	1975	[19]7,500	22,558.50	22,558.50
Maddox	1976	[19]7,500	22,502.25	22,502.25

Each petitioner's claimed fair market value is the BFL catalog retail list price for his respective allocated books. This figure was supplied to each petitioner by RPI on the section 170 statement each received from RPI. The lesser deductions claimed by McCall in 1975 and by McDermid in 1976 reflect the 30-percent limitation of section 170(b)(1)(C) on contributions of property. Pursuant to section 170(b)(1)(C), both McCall and McDermid attempted to carry over their unused contribution into subsequent years. Except for Neely in 1976, each petitioner attached to his respective return the section 170 statement furnished by RPI. Each petitioner actually paid to RPI as the cost of his subscription the cost figures listed above.

ULTIMATE FINDINGS OF FACT

(1) Each of the petitioners purchased reprint books and made a contribution of those books to a qualified donee library.

(2) The fair market value of the books so contributed is no more than 20 percent of BFL's catalog retail list prices.

OPINION

This case involves charitable contributions deductions claimed by the petitioners for their participation in a charitable contributions tax shelter program promoted by Reprints, Inc. (RPI), and its president and sole stockholder, Thomas Joiner (Joiner). Each petitioner "subscribed" to "units of participation" in RPI's "book contribution program." Each petitioner paid cash to RPI and received documents entitled "bill of sale" and "warehouse receipt" and an attached list of

[19]Although the parties stipulated that Maddox paid $10,000 in both 1975 and 1976, we are satisfied that the $7,500 figure is correct for both years. Maddox' subscription agreement shows the purchase of six units, three in 1975 (part I of the 1975 program) and three in 1976. RPI's 1975 offering memorandum lists the subscription price at $2,500 per unit and Maddox' subscription agreement states he had enclosed a check for $7,500, not for $10,000. Moreover, the claimed value of his contributions in both years, approximately $22,500, is more consistent with a purchase price of $7,500 than of $10,000, especially in light of the consistent three-for-one approach in RPI's tax shelter program.

books. These documents purported to evidence a purchase by each petitioner of reprint books published by BFL Communications, Inc. (BFL). Each petitioner purportedly purchased a quantity of BFL reprint books having aggregate publisher's catalog retail list prices in an amount 3 times the subscription price.

At the time these books were allocated to petitioners, RPI usually had already tentatively located libraries that were willing to receive reprint books they had selected. The allocation of books to petitioners thus corresponded to RPI's initial tentative allocation of books to those recipient libraries. Towards the end of each taxable year, RPI sent forms to the petitioners requesting "instructions" as to how petitioners wanted to dispose of their "books," specifically whether petitioners wanted to have RPI "consummate" their "donations" to the recipient libraries already tentatively identified, or whether they wished some other "disposition" of their "books." Each petitioner executed a form purporting to designate Joiner, RPI's president, as his "attorney in fact" for purposes of making a charitable contribution of his books. Each petitioner also signed the second endorsement on his warehouse receipt document or documents. At the same time, RPI again contacted the participating libraries tentatively selected as recipients to confirm their continuing willingness to receive the books. Each participating library was a qualified charitable donee under section 170, and each library executed a "special power of attorney" form purporting to designate Joiner as its "attorney in fact" for purposes of receiving and acknowledging the gift of books from the particular petitioner. Joiner, in his purported dual-agent capacity, executed a two-part document for each matched petitioner and library. The first part (as the petitioner's "attorney in fact") purported to declare a gift of books to the library, and the second part (as the library's "attorney in fact") purported to indicate the acceptance of such gift on behalf of the library. From the dates of the various "acceptance of subscription," "bill of sale," and "warehouse receipt" documents to the dates of each corresponding "deed of gift" and "acceptance of gift" document, each respective petitioner had "held" his "books" for slightly over 6 months, the capital gains holding period at that time. Joiner directed Embassy Book Services, Inc. (Embassy), the

warehouseman, to deliver the respective books to the respective libraries. Each library received the books purportedly given to it by the particular petitioner through Joiner. Each library executed a form entitled "acknowledgement of receipt," dated in the subsequent taxable year. RPI prepared the section 170 statement for petitioners to attach to their tax returns in claiming their charitable contributions of property. Each petitioner claimed a charitable contributions deduction for his gift of books to the various libraries, stating as the fair market value thereof the full catalog retail list prices charged by the publisher (BFL), an amount 3 times what each petitioner had paid for his alleged purchase of books.

Section 170(a)(1) allows as a deduction any contribution or gift to or for the use of an entity described in section 170(c), payment of which is made within the taxable year.[19] Where a taxpayer makes a contribution in property rather than cash, the amount of the charitable contribution deduction is generally the fair market value of the property at the time of the

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[19] As in effect during the years in issue, sec. 170 provided in pertinent part:

(a) ALLOWANCE OF DEDUCTION.—

(1) GENERAL RULE.—There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year. * * *

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(c) CHARITABLE CONTRIBUTION DEFINED.—For purposes of this section, the term "charitable contribution" means a contribution or gift to or for the use of—

(1) A State, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes.

* * * * * * * *

(e) CERTAIN CONTRIBUTIONS OF ORDINARY INCOME AND CAPITAL GAIN PROPERTY.—

(1) GENERAL RULE.—The amount of any charitable contribution of property otherwise taken into account under this section shall be reduced by the sum of—

(A) the amount of gain which would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution), and

(B) in the case of a charitable contribution—

(i) of tangible personal property, if the use by the donee is unrelated to the purpose or function constituting the basis for its exemption under section 501 (or, in the case of a governmental unit, to any purpose or function described in subsection (c)), or

(ii) to or for the use of a private foundation (as defined in section 509(a)), other than a private foundation described in subsection (b)(1)(D),

50 percent (62 ½ percent, in the case of a corporation) of the amount of gain which would have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution).

For purposes of applying this paragraph (other than in the case of gain to which section 617(d)(1), 1245(a), 1250(a), 1251(c), 1252(a), or 1254(a) applies), property which is property used in the trade or business (as defined in section 1231(b)) shall be treated as a capital asset.

contribution. Sec. 1.170A–1(c)(1), Income Tax Regs.[20] However, the amount of any charitable contribution of property otherwise allowable is reduced by any ordinary gain the taxpayer would have recognized if he had sold rather than contributed the property. Sec. 170(e)(1)(A), note 19 *supra*. During the years in issue, the capital gains holding period was 6 months. Sec. 1223. In disallowing petitioners' claimed charitable contributions deductions in their entirety, respondent makes two principal arguments, which we shall address separately.

I. Did Petitioners Make Charitable Contributions?

Respondent does not argue that the various documents purporting to evidence petitioners' acquisition and disposition of the books were not properly executed according to their terms by the various parties. Respondent does not seriously dispute the efficacy of these documents under State law. Indeed, respondent states that the effect of these documents under State law is "largely irrelevant." Finally, respondent concedes that the various libraries participating in RPI's book contribution program are all qualified charitable donees under section 170(c), and he admits that these libraries actually received the books that petitioners say they donated. Nonetheless, citing *Gregory v. Helvering*, 293 U.S. 465 (1935), respondent argues substance over form, contending that these various documents merely constitute a transaction wholly lacking in economic substance and reality, a sham transaction that should be completely disregarded for Federal tax purposes. Respondent argues that petitioners neither owned nor contributed books to the libraries, and that any contributions that were made were made by RPI, not petitioners. Respondent says that petitioners purchased tax deductions, not books. We cannot agree.

Respondent spent a great deal of time attempting to show that petitioners were completely inexperienced in every aspect of the book business and that petitioners had virtually no chance of realizing an economic profit from their alleged

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[20] As in effect during the years in issue, sec. 1.170A–1(c)(1), Income Tax Regs., provided:

"If a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution reduced as provided in section 170(e)(1) * * *"

acquisition and disposition of the reprint books. The record abundantly establishes that to be the case. Although we accept the truth of these matters, we have made no express findings on these facts because they are not pertinent to our inquiry. The deduction for charitable contributions provided by section 170 is a legislative subsidy for purely personal (as opposed to business) expenses of a taxpayer. Cf. *Davidson v. Commissioner*, 82 T.C. 434, 440–441 (1984). Accordingly, doctrines such as business purpose and an objective of economic profit are of little, if any, significance in determining whether petitioners have made charitable gifts. Cf. *Estelle Morris Trusts v. Commissioner*, 51 T.C. 20, 38–39, 43–44 (1968), affd. per curiam 427 F.2d 1361 (9th Cir. 1970); *Oakes v. Commissioner*, 44 T.C. 524, 532 (1965). We think that the various documents in fact comport with the economic substance and reality of these transactions, and we conclude that the petitioners did in fact own and contribute the books to the various libraries. Cf. *Dolese v. Commissioner*, 82 T.C. 830, 836–838 (1984).

First, petitioners obtained title to the books no later than the time they received the "bill of sale" and "warehouse receipt" documents from RPI. Uniform Commercial Code (UCC) secs. 2-401(3)(a), 1–201(14) and (15) (1976).[21] Since the warehouse receipt documents provided for delivery by the warehouseman, Embassy, to RPI's "order," the warehouse receipts were negotiable (U.C.C. sec. 7–104(1)(a) (1977)),[22] and accordingly, the risk of loss passed to the petitioners upon their receipt of the warehouse receipts. U.C.C. sec. 2–509(2)(a) (1976).[23] Consequently, upon receipt of the warehouse receipts, each petitioner's cash investment was fully subject to the risk

[21] See Fla. Stat. Ann. secs. 672.401(3)(a), 671.201(14) and (15) (West 1966, 1984 Supp.); Ga. Code Ann. secs. 11–2–401(3)(a), 11–1–201(14) and (15) (1982); N.J. Stat. Ann. secs. 12A:2–401(3)(a), 12A:1–201(14) and (15) (West 1962); N.C. Gen. Stat. secs. 25–2–401(3)(a), 25–1–201(14) and (15) (1965); Tenn. Code Ann. sec. 47–2–401(3)(a) (1979); Tenn. Code Ann. sec. 47–1–201(14) and (15) (1984 Supp.). Although McDermid's bills of sale were unsigned, the warehouse receipt was endorsed, and it was delivery to him of the warehouse receipt that effected passage of title to him. Since McDermid and RPI otherwise performed the agreement according to the terms of the offering memoranda and other documents, we do not think that Joiner's failure to sign the McDermid bills of sale on behalf of RPI in any way affects the validity of the transaction.

[22] See Fla. Stat. Ann. sec. 677.104(1)(a) (West 1966, 1984 Supp.); Ga. Code Ann. sec. 11–7–104(1)(a) (1982); N.J. Stat. Ann. sec. 12A:7–104(1)(a) (West 1962); N.C. Gen. Stat. sec. 25–7–104(1)(a) (1965); Tenn. Code Ann. sec. 47–7–104(1)(a) (1979).

[23] See Fla. Stat. Ann. sec. 672.509(2)(a) (West 1966, 1984 Supp.); Ga. Code Ann. sec. 11–2–509(2)(a) (1982); N.J. Stat. Ann. sec. 12A:2–509(2)(a) (West 1962); N.C. Gen. Stat. sec. 25–2–509(2)(a) (1965); Tenn. Code Ann. sec. 47–2–509(2)(a) (1979).

that the books might be destroyed, lost, or stolen.[24] Each petitioner also bore the risk that RPI would not be able to find a library willing to receive his books. More importantly, each petitioner faced the risk, very real because of BFL's precarious financial condition, that BFL would go out of business and not only undermine each petitioner's substantiation of his claimed fair market value under the book contribution program, but also largely destroy any possible market for the books. Also, both Embassy and RPI were new corporations with little experience in the book industry. That the only insurance apparently obtained for petitioners' books by RPI was simply for the amounts of RPI's option price with Embassy (25 cents to 35 cents per book) underscores the very real financial risk undertaken by petitioners.[25]

That petitioners never took actual physical possession of the books is also irrelevant. Although we look beyond bare legal title (see *Corliss v. Bowers*, 281 U.S. 376, 378 (1930)), it is the *right* to beneficial enjoyment of the property, and not the actual exercise of this right, that determines whether a taxpayer is to be recognized as the owner of property for Federal tax purposes. See generally *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237–1238 (1981);[26] *Yelencsics v. Commissioner*, 74 T.C. 1513, 1527 (1980). See also *Maysteel Products, Inc. v. Commissioner*, 33 T.C. 1021, 1025 (1960), revd. on another issue 287 F.2d 429 (7th Cir. 1961).

Respondent's reliance upon certain language in the documentation, such as "units of participation" and "subscription"

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[24] Petitioners' risk was subject, of course, to Embassy's liability for its negligent acts or omissions. U.C.C. sec. 7–204. See Fla. Stat. Ann. sec. 677.204 (West 1966, 1984 Supp.); Ga. Code Ann. sec. 11–7–204 (1982); N.J. Stat. Ann. sec. 12A:7–204 (West 1962); N.C. Gen. Stat. sec. 25–7–204 (1965); Tenn. Code Ann. sec. 47–7–204 (1979).

[25] Had the books been lost or destroyed, petitioners may have had a breach of contract claim against RPI for its apparent failure to fully ensure the books. Because RPI itself was recently incorporated by Joiner, its sole shareholder, and because RPI's bottom-line profits in the book contribution program were far less than the cash paid by the petitioners, such a breach of contract action against RPI would hardly be adequate to protect petitioners against financial loss.

[26] *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981), involved the question of whether a purported sale of cattle was to be recognized as a sale for Federal tax purposes. The Court found there was no sale because the taxpayers did not acquire the right to possession, control, or dominion over the cattle. Many of the factors listed in that case are relevant for determining ownership of property for Federal tax purposes generally—where legal title resides; the parties' treatment of the transaction; the parties' present obligations under the documents (execution of deed, payment, etc.); rights of possession; which party bears attendant costs, such as taxes; risk of loss or damage; and which party is entitled to any profits from the sale of the property.

and the like, is unavailing. Such terminology was used because RPI and its attorneys wanted to ensure that, if the book contribution programs were deemed "securities" under Federal or State securities laws, they would qualify for the "private offering" exception. The offering memoranda themselves so stated. Respondent's argument that the failure of the bill of sale documents to refer specifically to books meant that petitioners were not buying books is equally meritless. The bill of sale documents refer to the attached list of books. It is absolutely clear from the context of all the documents that RPI's program contemplated that the petitioners were purchasing books. Based on all the facts of this case (see *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. at 1237), we are convinced that petitioners did in fact purchase books from RPI.

We are likewise convinced that petitioners actually contributed their books to the libraries. Since the petitioners were in fact the owners of the books, we reject respondent's assertion that any transfer of the books to the libraries was by RPI rather than by petitioners. RPI did not own the books; consequently, RPI could not, except as petitioners' agent, transfer those books to the libraries. RPI's continuing actions in the book contribution programs, specifically its request for instructions from the taxpayers and corresponding inquiries to proposed recipient libraries, do not evidence any dominion over the books on RPI's part. RPI's actions were merely part of the services RPI promised to perform for petitioners, as set forth in the offering memoranda, and part of what petitioners paid for under their contracts.

Petitioners' post-dating of their endorsements of the warehouse receipts is also of little consequence. Petitioners' endorsement in blank of the warehouse receipts did not constitute a negotiation of those documents. Such negotiation was completed only upon delivery of the documents of title. U.C.C. sec. 7-501(1) and (3) (1977).[27] There was no delivery until at least the time Joiner executed the respective declarations of gift on behalf of the respective petitioners.

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[27] See Fla. Stat. Ann. sec. 677.501(1) and (3) (West 1966 & Supp. 1984); Ga. Code Ann. sec. 11-7-501(1) and (3) (1982); N.J. Stat. Ann. sec. 12A:7-501(1) and (3) (West 1962); N.C. Gen. Stat. sec. 25-7-501(1) and (3) (1965); Tenn. Code Ann. sec. 47-7-501(1) and (3) (1979).

Neither does petitioners' use of Joiner as an agent undermine the reality and substance of the transactions as gifts by the petitioners. Although a charitable contribution is not made until delivery of the gift is accomplished (sec. 1.170A–1(b), Income Tax Regs.), a charitable contribution may be effected through an agent acting on behalf of the donor, and may be made to an agent acting on behalf of the donee. See *Greer v. Commissioner*, 70 T.C. 294, 304 (1978), affd. on other issues in an unpublished opinion 634 F.2d 1044 (6th Cir. 1980); *Broussard v. Commissioner*, 16 T.C. 23, 27 (1951); *Mellon v. Commissioner*, 36 B.T.A. 977, 1065 (1937). See also *Dulin v. Commissioner*, 70 F.2d 828, 830 (6th Cir. 1934); *Guest v. Commissioner*, 77 T.C. 9, 16–17 (1981); *Witt's Estate v. Fahs*, 160 F. Supp. 521 (S.D. Fla. 1956). The crucial question in such cases is whether the donor has effectively parted with dominion and control over the subject matter of the gift. See *Guest v. Commissioner*, 77 T.C. at 15–17; *Glynn v. Commissioner*, 76 T.C. 116, 122 (1981), affd. without published opinion 676 F.2d 682 (1st Cir. 1982); *Londen v. Commissioner*, 45 T.C. 106, 110 (1965). All of the power of attorney forms signed by petitioners appear facially proper and sufficient to denominate Joiner as agent for the limited purpose of making the gift of books to the libraries. Likewise, the libraries' respective power of attorney forms appear equally sufficient and proper to designate Joiner as their agent to receive the books. We think that petitioners' dominion over the books ended when Joiner, on behalf of the various libraries, acknowledged the gifts.[28]

It is clear that petitioners, not RPI or Joiner, decided what to do with their respective books. Petitioners, not RPI or Joiner, decided that the books would be contributed to the various libraries. This is underscored by the fact that several of the RPI program subscribers (including petitioner Maddox) themselves located and designated the libraries to receive

[28] Joiner's dual status as agent of both the donor taxpayers and the donee libraries does not invalidate the agency relationship for tax purposes. The fact remains that the libraries did receive the various books at the direction of the respective petitioners. Disregarding Joiner as agent of the libraries would postpone delivery for tax purposes until actual receipt by the libraries. However, respondent has not disputed the timing of petitioners' charitable contributions deductions by seeking to disregard Joiner as agent of the libraries; he disputes the fact of contributions at all. Accordingly, we do not address the question of the timing of the contributions resulting from Joider's dual agency. But see *Witt's Estate v. Fahs*, 160 F. Supp. 521 (S.D. Fla. 1956), recognizing the U.S. mail as dual "agent" of both donor and donee, and *Broussard v. Commissioner*, 16 T.C. 23 (1951), recognizing the taxpayer as the donee's "agent."

their books, rather than relying upon RPI. Other subscribers, including some of the lead petitioners in these cases, seriously considered donating their books to libraries (or schools) other than those located by RPI. We would be more sympathetic to respondent's substance over form argument if the facts showed that RPI disregarded the wishes or directions of the various petitioners or of the libraries, but the facts of record are otherwise. RPI scrupulously observed and recognized petitioners' status as owners of the books and meticulously followed their directions in disposing of the books.

Despite his protests to the contrary, respondent's seeming obsession with the mechanics of these transactions as shams appears to be caused by the admitted tax-avoidance motivation of the various petitioners. However, as stated above, the deduction for charitable contributions was intended to provide a tax incentive for taxpayers to support charities. Consequently, a taxpayer's desire to avoid or eliminate taxes by contributing cash or property to charities cannot be used as a basis for disallowing the deduction for that charitable contribution. See *DeWitt v. United States*, 204 Ct. Cl. 274, 503 F.2d 1406 (1974); *Waller v. Commissioner*, 39 T.C. 665, 676–677 (1963); *Maysteel Products, Inc. v. Commissioner*, 33 T.C. at 1024–1025.[29] Cf. *Estelle Morris Trusts v. Commissioner*, *supra*.

Respondent does not argue that petitioners retained actual beneficial use or enjoyment of the property they claimed to have contributed. Compare *Davis v. Commissioner*, 81 T.C. 806, 817 (1983). Neither does respondent contend that petitioners received some economic benefit or consideration, other than the expected tax deduction, as the quid pro quo for their charitable contributions. Compare *Singer Co. v. United States*, 196 Ct. Cl. 90, 449 F.2d 413 (1971); *Howard v. Commissioner*, 39 T.C. 833 (1963); *DeJong v. Commissioner*, 36 T.C. 896 (1961), affd. 309 F.2d 373 (9th Cir. 1962).

Under *Gregory v. Helvering*, 293 U.S. at 469, so heavily relied upon by respondent, the determinative question is "whether what was done, apart from the tax motive, was the thing which the statute intended." Here, at each petitioner's direction, various qualified charitable donees received gifts of books belonging to the respective petitioners. This is precisely

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[29] See also *Grossman v. Commissioner*, T.C. Memo. 1973-219.

the result intended by section 170. Petitioners owned the reprint books and made contributions of those books to the various libraries, and we hold that petitioners are entitled to deductions for their charitable contributions.

II. Fair Market Value of the Donated Books

The amount of the deduction to which each petitioner is entitled under section 170 for his contribution of books to the various libraries depends upon the fair market value of the books at the time of the contribution. Sec. 1.170A–1(c)(1), Income Tax Regs., note 20 *supra*. Section 1.170A–1(c)(2), Income Tax Regs., defines fair market value as—

> the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts. If the contribution is made in property of a type which the taxpayer sells in the course of his business, the fair market value is the price which the taxpayer would have received if he had sold the contributed property in the usual market in which he customarily sells, at the time and place of the contribution and, in the case of a contribution of goods in quantity, in the quantity contributed. The usual market of a manufacturer or other producer consists of the wholesalers or other distributors to or through whom he customarily sells, but if he sells only at retail the usual market consists of his retail customers.

Fair market value is a question of fact to be determined from the entire record. *Zmuda v. Commissioner*, 79 T.C. 714, 726 (1982), affd. 731 F.2d 1417 (9th Cir. 1984); *Estate of DeBie v. Commissioner*, 56 T.C. 876, 894 (1971).

In support of his position that petitioners' books were of negligible value, respondent called three expert witnesses, each of whom was preeminent in his field. Respondent's first witness, Kenneth S. Giniger, had extensive experience in the publishing industry, including experience as managing officer of many book publishers and as an independent consultant to other publishing companies. The author of 11 books and numerous other publications about the publishing industry, Giniger was also an assistant professor of publishing at New York University, teaching courses and seminars on the business of book publishing, book publishing and the law, and author-publisher agreements. Giniger concluded that the fair market value of the books given to the libraries by the respective petitioners was no greater than 10 percent of BFL's

catalog retail list prices. This 10-percent figure represented Giniger's opinion of the wholesale price that would be paid by a dealer in excess inventory.

Respondent's second expert witness, Leonard Shatzkin, also had extensive experience in the publishing industry, first in the mechanical aspects of book publishing and later in the business aspects of it. At the time of trial, Shatzkin was a publishing consultant. Shatzkin determined that the fair market value of the books was no greater than 5 cents each. Shatzkin derived this price from BFL's sale to Embassy in 1973, which he determined to be an "arm's-length" sale of excessive inventory between a willing buyer and seller.

Respondent's final expert witness was Andrew Farkas. Although Farkas had approximately 3 years' experience in the publishing industry, working for what was then the world's largest dealer in second-hand and scholarly reprint books, his major experience was in librarianship. Farkas was both director of libraries and a professor of library science at the University of North Florida. Farkas testified about general library acquisitions policies, both of an institutional academic library like the University of North Florida and also those of small rural public libraries. Farkas viewed RPI's book contribution program as essentially dumping, upon undertrained, inexperienced, and naive librarians at the small rural public libraries, books that were largely useless to those libraries. Farkas testified that the fair market value of the books was no greater than 55 cents per book, the aggregate sum of the maximum option price payable by RPI to Embassy, plus Embassy's maximum reimbursement for storage and shipping expenses, nominally payable by BFL but effectively paid by RPI. Farkas viewed this as a contemporaneous arm's-length price negotiated between RPI and Embassy and corroborated his conclusion by referring to BFL's 1977 sale of its remaining reprint inventory at approximately 53 cents per book.

Each of respondent's valuation witnesses had a basic flaw in his analysis—each determined fair market value essentially on a wholesale rather than a retail basis. Although the regulations under section 170 do not specify whether a wholesale or retail market is to be used, the answer clearly provided elsewhere is that the retail market must be used under the circumstances existing herein. See sec. 20.2031–1(b),

Estate Tax Regs.; sec. 25.2512–1, Gift Tax Regs.;[30] *Goldman v. Commissioner*, 388 F.2d 476, 478 (6th Cir. 1967), affg. 46 T.C. 136 (1966); *Anselmo v. Commissioner*, 80 T.C. 872, 881–884 (1983).[31] These analogous regulations and the pertinent case law thus direct us to look at the market in which the property ordinarily is sold to its ultimate consumer. With respect to the reprint books here in issue, that is clearly the retail market place, comprised largely of institutional buyers (libraries) and, to a minor extent, of individuals seeking a specific scholarly text published by BFL. Since all of respondent's expert witnesses focused primarily on wholesale prices paid by retail sellers of excess inventory, their use of an improper market renders their analyses and opinions of little assistance for our purposes.

We also do not think that the usefulness of these books to the recipient libraries, or the actual use or disposition of some of these books by some of the libraries, has any great bearing on the fair market value of the books. That the recipient libraries would not or could not have purchased these books does not mean that the books were worthless in the market in which they were ordinarily sold to ultimate consumers. Likewise, the subsequent "flea market" sales and abandonment of some of the books by some of the recipient libraries do not establish that the books were necessarily of no value or of only nominal value in their ordinary market. Cf. *McGuire v. Commissioner*, 44 T.C. 801 (1965). These recipient libraries, by and large, did not purchase BFL reprint books because those books were essentially college level research materials of little use to the vast majority of the patrons of those libraries. Nonetheless, many of the libraries shelved and circulated some of the RPI-BFL reprint books they received. Use of the property by the donee can be a factor in valuation. *Guggenheim v. Rasquin*, 312 U.S. 254, 257 (1941); *Cupler v. Commissioner*, 64 T.C. 946, 955 (1975). On the facts of this case, the use and disposition by the libraries tend to indicate a small value,

[30] The test of fair market value for estate and gift tax purposes is generally the same as that for charitable contribution deduction purposes. *United States v. Parker*, 376 F.2d 402, 408 (5th Cir. 1967); *Anselmo v. Commissioner*, 80 T.C. 872, 881 (1983).

[31] See also *Alma Piston Co. v. Commissioner*, T.C. Memo. 1976–107, affd. 579 F.2d 1000 (6th Cir. 1978).

but we cannot say, as respondent argues, that the reprint books were essentially worthless.[32]

In making their arguments on a fair market value, petitioners at least attempted to examine the proper market, i.e., the retail market to the ultimate consumers. Petitioners argue that the fair market value of these reprint books is BFL's catalog retail list prices.

To buttress their argument, petitioners rely upon actual sales of reprint books by BFL, the publisher, at its catalog retail list prices and upon retail prices in the antiquarian, out-of-print, or second-hand market of used original edition copies of identical titles, to the extent such prices in that antiquarian market reflect solely the informational content of the books (i.e., excluding collectibility factors). To establish this second point, petitioners' expert witness, John Albers, attempted to construct an elaborate statistical model to establish a correlation between BFL's catalog retail list prices and the retail prices (based solely on the informational content) of used original edition copies of identical titles in the antiquarian or second-hand book market. Albers concluded that there was a close correlation, but we disagree. The BFL reprint books were neither rare nor used, and they were not out of print in the sense that they were not readily available from the publisher, BFL. Without going into the details of Albers' methodology, or of his statistics generally, it is sufficient to state that we are adequately persuaded by respondent's rebuttal expert witness that Albers' conclusion is not statistically valid because of his failure to employ proper statistical techniques. Titles from certain BFL catalogs were over-sampled, and titles from certain other BFL catalogs were under-sampled. Moreover, Albers valued only 709 titles of the over 3,000 titles in the RPI book contribution program. Also, Albers valued only those titles as to which price information was readily and conve-

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[32] Moreover, these factors seem to relate more to respondent's arguments that, at the most, petitioners' deductions should be limited to their actual cash expenditure. While the libraries' use and disposition of these books might be useful in applying the limitation of sec. 170(e)(1)(B)(i) (see note 19 *supra*), our determination as to the fair market value of the books in this case renders it unnecessary to ascertain whether the libraries' use of these particular books was unrelated to their exempt function under sec. 170(e)(1)(B)(i). Our fair market value determination renders moot respondent's alternative argument that petitioners should be considered as dealers under sec. 170(e)(1)(A) (note 19 *supra*). In other words, since we find the fair market value to be less than the cash paid for each taxpayer's subscription to the RPI book contribution program, we need not address any of respondent's alternative arguments.

niently available to him. The absence of price information might well suggest that there was no market for the title at all.

However, the major flaw in petitioners' valuation approach—in the reliance upon both retail sales by the publisher (BFL) and retail sales of the same titles (based on informational content) in the second-hand, antiquarian market—is petitioners' failure to consider the sheer numbers of books that are to be valued for each petitioner. As against this, the information relied upon by petitioners is simply insufficient to represent the large universe of reprint titles the Court is called upon to value.

As detailed in our findings of fact, when BFL's reprint book sales to Miami-Dade Public Library and Evergreen State College are excluded from the documented sales, BFL's actual sales of the reprint titles offered under RPI's program are negligible (only 15.0 and 13.3 percent of the titles in the RPI program, and an average of .16 and .145 copes per title). Even including the Miami-Dade and Evergreen sales,[33] the number of books sold to just the five lead petitioners in this case exceeded BFL's total documented sales of the RPI titles for 1975 and 1976. As further detailed in our findings of fact, approximately 98.8 percent of the available 2,678 titles in RPI's 1975 program were sold to the five lead petitioners. Among the five, they received an average of 5.5 copies per title, which exceeded the 4.72-copies-per-title average sales of these same titles (even including Miami-Dade and Evergreen sales) by BFL during 1975 and 1976.[34]

When the average of book quantities sold to the lead petitioners is extrapolated to all 11 taxpayers in these consolidated cases, it becomes obvious that the sheer quantity of books in the RPI book contribution program substantially exceeds BFL's total 1975 and 1976 sales of all reprint titles, even including the Evergreen and Miami-Dade sales. Moreover, when the average of those book quantities is extrapolated

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[33] Respondent strongly argues that we should ignore the Evergreen and Miami-Dade sales. Although respondent has the better of the argument, our ultimate determination of fair market value is unaffected by the inclusion or exclusion of the Evergreen and Miami-Dade sales.

[34] Because only one of the five lead petitioners (Lynn) participated in RPI's 1976 program, the direct comparison of BFL sales of the same titles to RPI's sale to Lynn is not as stark as the 1975 data. However, looking just at Lynn alone, he received copies of 65.2 percent of the titles offered exclusively under RPI's 1976 program, receiving an average of 2.4 copies per title.

to the approximately 40 separate taxpayer participants in RPI's book contribution program, BFL's actual sales of all reprint titles during the 2-year period, even including the Evergreen and Miami-Dade sales, become insignificant in comparison.[35] Most of BFL's actual documented sales were of titles not included in the RPI book contribution program.[36] Even if we accepted BFL's catalog list price at face value, we think the sheer number of books to be valued for each petitioner would require a substantial discount from that price. The simultaneous marketing of all those books would substantially depress the market for each particular reprint title and for the multiple copies of each title. See note 35 *supra*. See *Jarre v. Commissioner*, 64 T.C. 183, 189–190 (1975); *Estate of Smith v. Commissioner*, 57 T.C. 650 (1972), affd. on other issues 510 F.2d 479 (2d Cir. 1975).

Moreover, petitioners' reliance upon the publisher's catalog retail list prices for these books is also flawed because it ignores the fact that the reprint books in the RPI programs represented BFL's excess inventory. The parties' various expert witnesses expressed divergent views on the applicability of certain concepts of the general publishing market to the

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[35]Approximately 150,000 books were cycled through RPI's contribution program. This 150,000 figure is the approximate number available under RPI's option, and equals the approximate number disposed of by Embassy between its original acquisition of the 500,000 excess BFL books in 1973 and its 1977 resale of 350,000 of those books to BFL. Since slightly over 3,000 separate titles were available to RPI, this would indicate that an average of approximately 50 copies per title were cycled through RPI's contribution program.

[36]Petitioners argue, however, that BFL's actual sales were much higher than those documented sales upon which we have based our findings of fact. Harvey Roth, BFL's president during 1975–76, so testified. An officer of a large Georgia book wholesaler (Baker & Taylor) also testified that his employer had purchased approximately $136,000 worth of books from BFL in 1975, receiving a discount of 10 percent off BFL's list prices. However, since Baker & Taylor did not maintain any inventory of BFL reprint books and purchased them only as requested by their customers, the Court assumes that most, if not all, of these sales are already included in the Form 10-K figures discussed below. Petitioners pointed to BFL's financial statements taken from Forms 10-K filed with the Securities and Exchange Commission, showing total sales of approximately $1.3 million in 1975 and $900,000 in 1976. This evidence was equivocal at best. None of it relates to the specific titles offered under RPI's book contribution programs, only 3,000 of the approximately 7,000 titles BFL sold. BFL's documented sales, upon which we have based our findings, show that greater than a majority of such sales (and over 80 percent excluding the Evergreen and Miami-Dade sales) were of titles *not* offered in RPI's programs. There is no basis for inferring that the split would be any different among any additional undocumented sales. The actual amounts of BFL's undocumented sales of RPI's reprint titles were also less than they first appear to have been. The total sales shown on BFL's Forms 10-K to the SEC also include sales by a subsidiary, Nash Publishing, which did not sell any of the reprint titles and sold only original works (trade publications or trade books). Moreover, these sales figures also appear to include BFL's commissions from RPI, which, over the period should have been approximately $200,000 to $250,000. In short, the evidence of additional sales by BFL of the BFL - RPI titles is not persuasive.

"specialized" reprint market. Accordingly, we have refrained from characterizing BFL's sale to Embassy or any of the other transactions as "remainder" sales, whether "full" or "partial." While the parties dispute terminology and certain basic concepts, they do not, and cannot, seriously dispute that BFL's 1973 sale to Embassy of 500,000 reprint books was a disposition by BFL of its excess inventory, that is to say, inventory that it was unable to sell in the ordinary course of its business. The test of fair market value contemplates a willing seller and a willing buyer, both with knowledge of all the relevant facts. A willing retail buyer of the reprint books owned by petitioners would know that those books constituted excess inventory of the publisher. Such a knowing buyer would demand and receive a substantial discount for his purchase of any of this excess inventory, particularly for a quantity of 2,000 to 3,000 books such as some of the libraries received, regardless of whether it was called a full remainder, a partial remainder, or some other colorful nomenclature.

Petitioners' approach also ignores the overall weakness of the market for scholarly reprint books during the 1970's. As detailed in our findings, Government funding for library book acquisitions was severely cut, sharply reducing the demand for these kinds of books. A large number of reprint publishers were forced out of business by the diminished market of the 1970's. In 1977, shortly after RPI wound up its reprint book contribution program, BFL itself was forced to sell its remaining inventory and to terminate its reprint business. Since BFL itself could not stay in business selling its books at its catalog retail list prices, it is wholly unrealistic to suggest that those catalog retail list prices accurately measure the fair market value of petitioners' BFL reprint books.

In some cases, such basic errors in valuation methodology by both parties might leave the Court with no factual basis for determining the fair market value, resulting in a determination based solely upon burden of proof. See *Anselmo v. Commissioner*, 80 T.C. at 885–886. Fortunately, we need not rely upon burden of proof, for, after sifting through the mountains of chaff[37] in these consolidated cases, a few grains

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[37] This case was tried and briefed exhaustively by the parties. Respondent's brief contained 674 requested findings of fact and petitioners' brief contained 252, with lengthy objections by each side to a majority of the findings proposed by the opposing side. Actually, most of the basic facts in the

of wheat remain. Giniger, one of respondent's experts did discuss the retail price ranges charged by a dealer in excess inventory books. Giniger testified that such a dealer would normally purchase a publisher's excess inventory at 5 to 10 percent of the publisher's catalog list price and attempt to resell those books to its own customers at 3 to 4 times his own cost. Both the dealer's purchase price and his markup would depend upon the quantity of books he purchased and upon his perception of the turn-around time to sell them. Such a dealer would pay the publisher less and mark up more for larger quantities of books that he could not quickly resell. Accordingly, such a retail dealer's retail prices to the ultimate consumers would generally range between 15 to 30 percent of the publisher's list price.

Although the number of books to be valued in this case is exceedingly large, and although the market for scholarly reprint books was weak, both the sales by BFL and the sales of some of the same titles (based on informational content) in the second-hand or antiquarian market, indicate that there was some demand for some of the BFL titles offered under RPI's contribution program. For that reason we cannot accept respondent's argument that petitioners' books were worthless. Since we think these books had some value and that there was some market for the books, albeit a weak one, we conclude that the fair market value can reasonably be found in this range of 15 to 30 percent of the publisher's catalog retail list prices. *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930).

Our conclusion is bolstered by another pertinent factor, namely, RPI's total cash price (which was contemporaneous with petitioners' on purchases) for these books—16.67 percent and 18.17 percent of BFL's catalog retail list price. Cf. *Siegel v. Commissioner*, 78 T.C. 659, 686–688 (1982). As detailed in our findings of fact, these figures actually represented RPI's total cash price paid to Embassy and BFL. Contrary to respondent's argument, RPI's cash price was *not* a function of the contemplated tax benefits to the ultimate book contribution program participants.[38] BFL had already sold its excess inventory to

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case were little disputed, but both parties labored long and hard to put their differing "gloss" or "twist" upon almost every requested finding.

[38] Conversely, the cash price paid *to RPI* by the petitioners was, in large part, a function of their contemplated "tax profit." These 50-percent bracket taxpayers, claiming charitable contributions

Embassy at 5 cents per book. Because of the restriction against domestic resale by Embassy, BFL was protected against any impairment of its domestic market by Embassy's sale of this excess inventory. In the transaction with RPI, BFL consciously bargained away that restriction on domestic resale in exchange for the negotiated commission. We think this price was set largely by arm's-length bargaining among RPI (Joiner), BFL, and Embassy. On the one hand, RPI was motivated to pay the lowest possible price to both BFL and Embassy in order to maximize its profits on its resale of the books to participants in the tax shelter program. BFL and Embassy, knowing that RPI could not put together its program without the waiver of the restriction on domestic sales, were in a position to hold out for as much as they could reasonably extract from RPI. Moreover, if anything, the commissions RPI paid to BFL (effectively RPI's total cash price) were somewhat *less* than fair market value of those books. Although BFL waived the *legal* restriction on domestic retail sale and distribution, as a practical matter, BFL knew that RPI's resale and the petitioners' contributions of these books to libraries would not significantly affect the domestic market for its books because virtually all such books were going to end up in the hands of small rural public libraries that were *not* BFL's primary customers. Had BFL believed that RPI's book contribution program would endanger its domestic market, BFL undoubtedly would have held out for a higher price.

In determining the fair market value of these BFL reprint books, we recognize that our task involves an "inherently imprecise process" and is "capable of resolution only by Solomon-like pronouncement." See *Estate of Smith v. Commis-*

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3 times their cash investment, expected to reap a tax profit (tax reduction) 1⅓ times their cash investment. Since their cash price was artificially set to give RPI its cash profit and the taxpayers their expected tax profit, we do not consider their actual cash investment relevant in ascertaining the actual fair market value of the books *as books*. Moreover, the subscription prices paid to RPI by the petitioners covered more than just what they paid for the books as books: Those prices included, in addition to RPI's profit (some 20 percent of the subscription price), some amounts for insurance, storage, packaging, shipping, and other services of the book contribution program. For these reasons, we reject any suggestion that the fair market value of the books must be no less than what petitioners actually paid to RPI. We are keenly aware that petitioners could have donated $10,000 in cash to the libraries directly and would be entitled to a deduction for the full amount of their cash contribution. We are also well aware that some of these petitioners candidly admitted they would not have entered into the book contribution program if they had thought their deduction would be limited to their out-of-pocket cash expenditure. Those factors are irrelevant. The contributions to the libraries were contributions of books, and our task is to determine the fair market value of the books as books.

sioner, 57 T.C. at 655; *Messing v. Commissioner*, 48 T.C. 502, 512 (1967). However, exercising our best judgment based on all the pertinent facts of record in this case—particularly the sheer volume of BFL reprint books cycled through RPI's contribution program, the large number of books these petitioners acquired, the nature of these books as BFL's excess inventory, and the depressed market conditions—we conclude that the fair market value of the books contributed by the petitioners was no more than 20 percent of the BFL catalog retail list prices for these books. That is the amount of petitioners' allowable deductions for their charitable contributions of books to the libraries.

To reflect this holding,

Decisions will be entered under Rule 155.

ESTATE OF GERALDINE W. HARMON, DECEASED, WALTER I. BREGMAN, EXECUTOR, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 14654–81. Filed February 28, 1985.

D died testate in California. By her will, D gave her condominium and its contents to her husband, but she also made an alternate gift of such property in the event that her husband did not "survive distribution of * * * [her] estate." D's husband survived her death and survived the probate court's entry of the decree of final distribution of her estate. *Held*, the disposition to D's husband created a terminable interest under sec. 2056(b), I.R.C. 1954, for which no marital deduction is available, because such disposition would have terminated or failed if he had not survived the entry of the final decree of distribution of her estate.

Michael L. Gianelli, for the petitioner.
Charlotte Mitchell, for the respondent.

SIMPSON, *Judge*: The Commissioner determined a deficiency of $41,174 in the estate tax due from the Estate of Geraldine W. Harmon. The sole issue for decision is whether a gift to the husband of the decedent subject to his surviving distribution of

her estate created a terminable interest under section 2056(b) of the Internal Revenue Code of 1954[1] for which no marital deduction is available.

FINDINGS OF FACT

Some of the facts have been stipulated, and those facts are so found.

Walter I. Bregman, the son of Geraldine W. Harmon and the executor of her estate, had his legal residence in Stamford, Connecticut, at the time he filed the petition in this case. He timely filed an estate tax return with the Internal Revenue Service Center, Fresno, California.

Geraldine W. Harmon (the decedent or Mrs. Harmon) died on December 5, 1977. Prior to her death, she resided with her husband, Sidney Harmon, in a condominium located in Rancho Mirage, California. The condominium was Mrs. Harmon's separate property.

Mr. and Mrs. Harmon were married in 1971 when Mrs. Harmon was about 61 years old and Mr. Harmon was about 64 years old. They had no children of their marriage. Mr. Harmon had been married twice previously. He had four children from his second marriage, all of whom were alive and adult at the time of Mrs. Harmon's death. Mrs. Harmon had been married once previously and had one child, Walter I. Bregman, from that marriage. Relations between Mr. and Mrs. Harmon and their separate families were amicable.

At the time of their marriage, Mrs. Harmon owned real and personal property with an estimated net value of $1 million, while Mr. Harmon owned personal property with an estimated net value of $200,000, and no real property. Before their marriage, they executed an antenuptial agreement by which they agreed that all property owned by each party prior to their marriage, and all property coming to each party from whatever source during the marriage, was to remain separate property. They both also waived all community property rights, all rights as an heir or surviving spouse, all rights to a family allowance or probate homestead, all rights in the event of death, and all right to act as administrator of the estate of

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[1] All statutory references are to the Internal Revenue Code of 1954 as in effect during the year in issue, unless otherwise indicated.

the other. However, during their marriage, the decedent and Mr. Harmon did share a joint bank account and expenses.

Mrs. Harmon executed her will on June 12, 1974. The pertinent provisions of the will are as follows:

> THIRD: I hereby give, devise and bequeath all tangible personalty and the condominium located at Tamarisk West, Rancho Mirage, California to SIDNEY HARMON. If SIDNEY HARMON *fails to survive distribution of my estate*, then in that event I hereby give, devise and bequeath the tangible personalty [sic] property and condominium to my son WALTER I. BREGMAN.
>
> FOURTH: (A) I give and bequeath all of my jewelry to my beloved son, WALTER I. BREGMAN, but should he predecease me, then I give this bequest to my sister, SHIRLEY W. BERNSTEIN.
>
> * * * * * * *
>
> (C) I give and bequeath the sum of Two Hundred Thousand Dollars ($200,000.00) to the BANK OF AMERICA, in trust.
>
> (1) The Trustee shall pay for the support of SHIRLEY BERNSTEIN the income from the Trust.
>
> (2) Upon the death of SHIRLEY BERNSTEIN the trust shall terminate and be distributed to my son WALTER BREGMAN.
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> * * * * * * *
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> FIFTH: I give, bequeath and devise to my son, WALTER I. BREGMAN, if living at the time of my death, all the rest, residue and remainder of my estate, * * *
>
> SIXTH: In the event that my said son, WALTER I. BREGMAN, shall predecease me, all the rest, residue and remainder of my estate, * * * I give, devise and bequeath to the BANK OF AMERICA, National Trust and Savings Association, as Trustee. Such Trust shall be known as the "Grandchildren's Trust" * * *
>
> [Emphasis added.]

The June 1974 will revoked a will that the decedent had executed in June 1972, shortly after she married Mr. Harmon. In the earlier will, the decedent had left all of her estate to her son, or if he predeceased her, to her grandchildren, in trust. She executed the June 1974 will when she became concerned about the future financial needs of her husband and of her sister, Shirley Bernstein. In addition to providing a trust fund for her sister's support, Mrs. Harmon wanted to insure that Mr. Harmon would be able to continue residing in the Rancho Mirage condominium after her death as Mr. Harmon had no residence of his own and his separate personal property had

become substantially depleted since their marriage. By codicil executed in September 1975, Mrs. Harmon also bequeathed $75,000 to a trust, with the income payable to Mr. Harmon during his life and the corpus to be distributed to her son on Mr. Harmon's death. However, upon Mrs Harmon's death, the bulk of her estate would still pass to her son. The revoked will, the 1974 will, and the codicil were all prepared by the decedent's attorney, H. Morgan Dougherty.

A petition for the probate of the decedent's will and for letters testamentary was filed on December 15, 1977, in Riverside County, California. A judgment for final distribution of the estate was entered on January 8, 1979, in that county. Mr. Harmon survived the decedent's death and the entry of the judgment of final distribution.

The petitioner claimed a marital deduction of $117,175 on its estate tax return. In his notice of deficiency, the Commissioner disallowed $116,220 of the claimed marital deduction because he determined that paragraph "THIRD" of the decedent's will passed a nondeductible, terminable interest in the personal property and the condominium to her husband.

OPINION

The issue for decision is whether the gift of the personalty and condominium to Mr. Harmon subject to his surviving distribution of the estate of the decedent was a terminable interest within the meaning of section 2056(b) for which no marital deduction is allowable.

Section 2056(a) permits a deduction equal to the value of any interest in property which passes from the decedent to her surviving spouse to the extent that such interest is included in determining the value of the decedent's gross estate. However, section 2056(b) sets forth an exception for life estates and other terminable interests where the deduction will not be allowed:

> SEC. 2056(b). LIMITATION IN THE CASE OF LIFE ESTATE OR OTHER TERMINABLE INTEREST.—
>
> (1) GENERAL RULE.—Where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, no deduction shall be allowed under this section with respect to such interest—

(A) if an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse); and

(B) if by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse;

Section 2056(b)(3) sets forth guidelines whereby certain conditions of survivorship will not be deemed to create a terminable interest:

(3) INTEREST OF SPOUSE CONDITIONAL ON SURVIVAL FOR LIMITED PERIOD.—For purposes of this subsection, an interest passing to the surviving spouse shall not be considered as an interest which will terminate or fail on the death of such spouse if—

(A) such death will cause a termination or failure of such interest only if it occurs within a period not exceeding 6 months after the decedent's death, or only if it occurs as a result of a common disaster resulting in the death of the decedent and the surviving spouse, or only if it occurs in the case of either such event; and

(B) such termination or failure does not in fact occur.

The nature of a legal interest in property is a matter of State law, and therefore in the present case, we must look to California law to determine whether the disposition to Mr. Harmon under paragraph "THIRD" of the will might terminate or fail more than 6 months after the decedent's death. *Broday v. United States*, 455 F.2d 1097, 1099 (5th Cir. 1972); *Estate of Fulmer v. Commissioner*, 83 T.C. 302, 304 (1984); *Estate of Rubinow v. Commissioner*, 75 T.C. 486, 489 (1980). In making this determination, we are, "in effect, sitting as a state court," being bound by decisions of the Supreme Court of California and "giving 'proper regard' to relevant rulings of other courts of the State." *Commissioner v. Estate of Bosch*, 387 U.S. 456, 465 (1967); *Estate of Fulmer v. Commissioner, supra* at 306.

The petitioner's ultimate position is that the phrase "fails to survive distribution of my estate" contained in paragraph "THIRD" must be interpreted as synonymous with the phrase "fails to survive my death" in order to effectuate the intent of the decedent. The petitioner contends that the phrase "fails to survive distribution of my estate" is ambiguous and that the ambiguity is not removed by reference to anything else contained within the "four corners" of the will. We are therefore asked to consider extrinsic evidence, including the

circumstances surrounding the execution of the will and declarations of the decedent, in order to determine the decedent's intent. If we conclude that she intended that her husband need only survive her death in order to obtain an indefeasible interest in the condominium and its contents, then his interest is not a terminable interest, and the marital deduction is allowable.

The Commissioner, on the other hand, maintains that paragraph "THIRD" unambiguously conditions Mr. Harmon's interest in the condominium and its contents on his surviving not only the death of the testator but also the distribution of her estate. Such condition produces a terminable interest because distribution of the estate would not necessarily occur within 6 months of the death, and in fact, the decree of final distribution was issued more than 13 months after the death. The Commissioner objected at trial to the admission of any extrinsic evidence bearing on the decedent's intent. We reserved decision on the Commissioner's objection and now overrule it.

The cardinal rule in the construction of wills, to which all other rules must yield, is that a will is to be construed according to the intention of the testator, as expressed therein. *In re Estate of Dodge*, 6 Cal. 3d 311, 324, 491 P.2d 385, 394, 98 Cal. Rptr. 801, 810 (1971); *In re Estate of Wilson*, 184 Cal. 63, 66–67, 193 P. 581, 582 (1920); see Cal. Prob. Code sec. 101 (West 1956).[2] The intent of the testator is to be garnered from the language of the will itself. *Estate of Kaseroff*, 19 Cal. 3d 272, 275, 562 P.2d 325, 327, 137 Cal. Rptr. 644, 646 (1977).

In the past, California courts have refused to consider extrinsic evidence of the testator's intention unless it was necessary to explain an ambiguity appearing on the face of the will or to reveal the existence of a latent ambiguity which did not so appear. *In re Estate of Torregano*, 54 Cal. 2d 234, 246, 352 P.2d 505, 512, 5 Cal. Rptr. 137, 144 (1960); *In re Carter's Estate*, 47 Cal. 2d 200, 302 P.2d 301, 306 (1956); *In re Sargavak's Estate*, 41 Cal. 2d 314, 259 P.2d 897, 899–900 (1953). However, it is now well settled California law that a will must be examined "in the light of the circumstances surrounding its

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[2] All references to the Probate Code of California are to such code as in effect during the year in issue. The Probate Code has been substantially revised, effective Jan. 1, 1985. 1983 Cal. Stat. ch. 842.

execution so as to ascertain what the * * * [testator] meant by the words used. Only then can it be determined whether the seemingly clear language of the instrument is in fact ambiguous." *In re Estate of Russell*, 69 Cal. 2d 200, 444 P.2d 353, 359, 70 Cal. Rptr. 561, 567 (1968); see *In re Estate of Dodge*, 6 Cal. 3d at 318, 491 P.2d at 390, 98 Cal. Rptr. at 806; *Estate of Kime*, 144 Cal. App. 3d 246, 261–262, 193 Cal. Rptr. 718, 727–728 (Cal. Ct. App. 1983); *Hoover v. Hartman*, 136 Cal. App. 3d 1019, 1026, 186 Cal. Rptr. 669, 673 (Cal. Ct. App. 1982); *Wells Fargo Bank, National Association v. Huse*, 57 Cal. App. 3d 927, 932–933, 129 Cal. Rptr. 522, 525 (Cal. Ct. App. 1976). Thus:

> If in the light of such extrinsic evidence, the provisions of the will are reasonably susceptible of two or more meanings claimed to have been intended by the testator, "an uncertainty arises upon the face of a will" ([Cal. Prob. Code Sec.] 105) and extrinsic evidence relevant to prove any of such meanings is admissible (see [Cal. Prob. Code Sec.] 106), subject to the restrictions imposed by statute ([Cal. Prob. Code Sec.] 105). If, on the other hand, in the light of such extrinsic evidence, the provisions of the will are not reasonably susceptible of two or more meanings, there is no uncertainty arising upon the face of the will * * * and any proffered evidence attempting to show an intention *different* from that expressed by the words therein, giving them the only meaning to which they are reasonably susceptible, is inadmissible. * * * [*In re Estate of Russell*, 444 P.2d at 361–362, 70 Cal. Rptr. at 569–570; fn. ref. omitted; emphasis in original.]

In *Estate of Russell*, the California Supreme Court was careful to explain that the extrinsic evidence to be considered did not include oral declarations of the testator, as the introduction of such declarations is specifically prohibited by section 105 of California's Probate Code (444 P.2d at 361 n. 18, 70 Cal. Rptr. at 569 n. 18); but in a subsequent case, the same court freely admitted testimony respecting the testator's oral declarations once it had been established that a provision of the will was ambiguous (*In re Estate of Dodge*, *supra*; see also *Estate of Kime*, *supra*). Therefore, because we are, "in effect, sitting as a state court" (*Commissioner v. Estate of Bosch*, *supra*), we are compelled by the recent changes in California case law to examine the circumstances surrounding the execution of Mrs. Harmon's will, in addition to the language used therein, before we can determine whether the phrase "fails to survive distribution of my estate" is ambiguous. If we determine that such phrase is ambiguous, we may then

consider all relevant extrinsic evidence of Mrs. Harmon's intended meaning, including her oral declarations.

Among the circumstances surrounding the execution of the will which we must consider are the relevant statutes, case law, and public policy in effect at the time of the execution of the will; in the absence of a contrary intent, such law is deemed to become a part of the testamentary scheme. *Wells Fargo Bank, National Association v. Huse*, 57 Cal. App. 3d at 933, 129 Cal. Rptr. at 525; see *Estate of Carley*, 90 Cal. App. 3d 582, 153 Cal. Rptr. 528 (Cal. Ct. App. 1979). Moreover, where a will is drawn by an experienced and competent lawyer, there is a presumption that technical terms in the will were used in their technical sense, unless the will or the circumstances surrounding its execution clearly indicate that the technical term was not intended to have its technical meaning. *In re Estate of Dodge*, 6 Cal. 3d at 324, 491 P.2d at 394–395, 98 Cal. Rptr. at 809–810 (interpreting Cal. Prob. Code sec. 106 (West 1956)); see *Wells Fargo Bank, National Association v. Huse*, 57 Cal. App. 3d at 935, 129 Cal. Rptr. at 526.

In the present case, Mrs. Harmon and her attorney, H. Morgan Dougherty, employed the phrase "fails to survive distribution of my estate" in paragraph "THIRD" of her will. Such phrase has a well established, technical meaning in California probate practice. According to the court in *In re Rankin's Estate*, 118 Cal. App. 2d 184, 257 P.2d 95, 97 (Cal. Dist. Ct. App. 1953):

> It is doubtful that there are in the law and practice of wills and probate administration terms that are more commonly used than "distribution," "partial distribution" and "distribution of the estate." Anyone familiar with practices in probate would understand that "distribution of my estate" means distribution in probate. * * *

Thus, on numerous other occasions, California courts have determined that the phrase "distribution of my estate" means distribution of the estate by probate decree. *In re Dunphy's Estate*, 147 Cal. 95, 100, 81 P. 315, 317 (1905); *In re Newman's Estate*, 230 Cal. App. 2d 158, 40 Cal. Rptr. 785, 790 (Cal. Dist. Ct. App. 1964); see *In re Estate of Germond*, 4 Cal. 3d 573, 483 P.2d 769, 94 Cal. Rptr. 153 (1971); *In re Estate of Taylor*, 66 Cal. 2d 855, 428 P.2d 301, 59 Cal. Rptr. 437 (1967); *In re Jameson's Estate*, 93 Cal. App. 2d 35, 208 P.2d 54 (Cal. Dist. Ct. App.

1949); *In re Hampe's Estate*, 85 Cal. App. 2d 557, 193 P.2d 133 (Cal. Dist. Ct. App. 1948); *In re Clarke's Estate*, 103 Cal. App. 243, 284 P. 231 (Cal. Dist. Ct. App. 1930).

For example, in *In re Hampe's Estate, supra*, the testator left a specific legacy and a share of the residue of the estate to a niece, with the proviso that if the niece "shall die prior to distribution," her interests in the properties would fail and be given to two other named residuary beneficiaries. The niece survived the testator and survived a decree of partial distribution covering the legacy, but she died prior to the entry of the final decree of distribution. The court held that "The phrase 'die prior to distribution' as used in a will providing that a legacy shall lapse if the legatee 'dies prior to distribution' means that if the legatee is not alive on the date of the entry of the decree of distribution the legacy lapses." Therefore, the court found that all dispositions to the niece, including the specific legacy, lapsed. 193 P.2d at 135. See also *In re Estate of Germond, supra*; cf. *In re Estate of Taylor, supra*.[3] Likewise, in *In re Jameson's Estate, supra*, the court determined, without resort to extrinsic evidence, that a disposition of a life estate in real property to the testator's husband "If * * * [he] survives distribution of my estate" created a contingent interest in the property which did not vest until he survived the probate distribution of the estate. 208 P.2d at 57.

Section 1023 of the California Probate Code also indicates that testamentary dispositions conditioned on surviving distribution are an accepted practice in California estate planning. That section provides, in part, that if any heir, devisee, or legatee survives the testator but dies prior to distribution, a decree of final distribution purporting to make a distribution to such person by name rather than to his personal representa-

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[3] The Supreme Court of California in *In re Estate of Taylor*, 66 Cal. 2d 855, 428 P.2d 301, 59 Cal. Rptr. 437 (1967), adopted a rule to mitigate the harshness of the result in cases where a testamentary disposition is conditioned upon surviving distribution of the estate. The court acknowledged that survival until final distribution is normally a condition precedent to the vesting of the beneficiary's interest, but the court held that a distribution conditioned upon survival until "distribution of the estate" becomes indefeasibly vested upon the beneficiary's surviving the day distribution *ought* to have occurred rather than the day when the distribution actually occurred. 428 P.2d at 303, 59 Cal. Rptr. at 439. The rule of *Estate of Taylor* was subsequently considered in *In re Estate of Germond*, 4 Cal. 3d 573, 483 P.2d 769, 94 Cal. Rptr. 153 (1971), but in that case, the court found that the executor had not delayed final distribution of the estate unreasonably. However, neither *Estate of Germond* nor *Estate of Taylor* suggests that California courts would interpret such a disposition as vesting indefeasibly upon the beneficiary's surviving only the testator's death.

tive or estate shall have the same effect as though distribution had been made to him while living. However, the section further states that "where the share is purportedly distributed to him pursuant to the terms of a will which provides that he shall be entitled to the same only in the event he *survives the date of distribution*, then such purported distribution as to him shall be void." Cal. Prob. Code sec. 1023 (West 1981); emphasis added. Thus, California's probate scheme both anticipates and accommodates the use of a condition such as the one involved in the present case.

Although the technical meaning of the phrase "distribution of my estate" is well established, we must also consider the other circumstances surrounding the execution of Mrs. Harmon's will before we can determine the meaning of such phrase as used in her will. *In re Estate of Russell, supra.* Mr. Dougherty, the attorney who prepared the will, testified that, in his opinion, Mrs. Harmon meant "fails to survive my death" by use of the phrase "fails to survive distribution of my estate." Mr. Dougherty had "no recollection of her instructing me to impose any condition other than * * * [Mr. Harmon's] survival." Yet, he had no recollection that she specifically directed him to make the gift to Mr. Harmon subject only to his surviving her; nor could he explain why the technical phrase "fails to survive distribution of my estate" was used in paragraph "THIRD" when phrases that would have clearly expressed the decedent's purported intent (i.e., "should he predecease me," "if living at the time of my death," and "In the event that my said son * * * shall predecease me") were used in paragraphs "FOURTH," "FIFTH," and "SIXTH" of her will. Because of the passage of time between the execution of the will and the trial, Mr. Dougherty could not remember the exact manner in which the will was drafted. His best recollection was that he used Mrs. Harmon's June 1972 will as a form, making modifications on a copy of such will and then giving his secretary oral instructions as to the addition of the new provisions necessitated by Mrs. Harmon's altered intentions. The secretary would typically prepare such provisions with the aid of "form" wills, using language indicated by Mr. Dougherty.

Mr. Dougherty's testimony establishes at most that Mrs. Harmon could have intended that the bequest to Mr. Harmon

be contingent only upon his surviving her death, but his testimony does not conclusively prove that such was her intent. His opinion alone as to her intent is not sufficiently compelling in light of the fact that he supervised the preparation of the will and its use of the phrase "fails to survive distribution of my estate." It is difficult to believe that Mr. Dougherty, an experienced attorney, adopted such phrase thinking it expressed an intention different from its well established, technical meaning, particularly since he employed language which specifically conditioned other dispositions upon the beneficiary's surviving only Mrs. Harmon's death.

An examination of the remaining evidence of the circumstances surrounding the execution of Mrs. Harmon's will is similarly inconclusive as to her intent. At the time she executed her will, Mrs. Harmon was on good terms with her son, her husband, and her husband's children. In 1972, shortly after she married Mr. Harmon, Mrs. Harmon executed a will which left all of her estate to her son. However, in 1974, when she became concerned about the needs of her sister and her husband, she revoked such will and executed the will involved here. Mrs. Harmon informed her son that she had revoked the 1972 will and told him "I'm giving Sidney the condominium." The conversation with Mr. Bregman was brief, and there was no discussion of the condition contained in the disposition to Mr. Harmon. Mrs. Harmon likewise told Mr. Harmon that she had provided that he could stay on in the condominium after her death. Neither Mr. Bregman nor Mr. Harmon saw the will before her death. All that can be deduced from an examination of these extrinsic circumstances is that Mrs. Harmon wanted to insure that Mr. Harmon could live in the condominium after her death. Such purpose was effectuated by paragraph "THIRD" of her will regardless of whether we accept the petitioner's or the Commissioner's interpretation of its conditional language. These other circumstances are consequently of little assistance in divining Mrs. Harmon's intent.

We conclude that the petitioner has failed to prove that Mrs. Harmon intended the phrase "fails to survive distribution of my estate" to mean anything other than its understood meaning in California probate practice. Therefore, because the disposition contained in paragraph "THIRD" of the decedent's

will would have terminated or failed if her husband had not survived the issuance of the final decree of distribution, we hold that such disposition is a terminable interest within the meaning of section 2056(b) for which no marital deduction is available.

The result we reach is in accord with that of numerous estate tax cases where California law has been applied to a spousal disposition conditioned upon the spouse's surviving "distribution of * * * [the testator's] estate" (or a phrase of similar import). See *Mitchell v. United States*, an unreported case (C.D. Cal. 1971, 28 AFTR 2d 71-6209, 71-2 USTC par. 12,793); *Nielsen v. United States*, an unreported case (C.D. Cal. 1968, 22 AFTR 2d 6051, 68-2 USTC par. 12,549); *Farrell v. United States*, 198 F. Supp. 461 (S.D. Cal. 1961); *California Trust Co. v. Riddell*, 136 F. Supp. 7 (S.D. Cal. 1955); *Estate of Sbicca v. Commissioner*, 35 T.C. 96 (1960); *Estate of Street v. Commissioner*, 25 T.C. 673 (1955); see also sec. 20.2056(b)-3(d), example (*4*), Estate Tax Regs.; but see *Estate of Doughty v. United States*, an unreported case (C.D. Cal. 1969, 25 AFTR 2d 70-1451, 70-1 USTC par. 12,651).[4] The petitioner seeks to distinguish the cited cases, with the exception of *Farrell v. United States, supra*, on the ground that the language employed by the testator in each case more clearly indicated an intent to condition the disposition on survival of probate distribution than the words employed by the testator in the present case; in some of the cases, the will provided that the disposition would fail if the spouse "predeceased * * * [the testator], *or* does not survive distribution of * * * [the testator's] estate" (or words to that effect), while in the other cases the will provided that the disposition would fail if the spouse did not survive "the *decree of final distribution* of * * * [the testator's] estate" (or words to that effect) (emphasis added).

Although we agree that the testator's intent was more artfully expressed in the cited cases, we find that the same

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[4] In *Estate of Doughty v. United States*, an unreported case (C.D. Cal. 1969, 25 AFTR 2d 70-1451, 70-1 USTC par. 12,651), the court allowed a marital deduction for a disposition very like the one involved in the present case. The court found as a fact that the testator used the words "survive distribution of my estate" to mean "the passing of title to such estate at the time of his decease," which was the equivalent of "fail to survive my death." However, *Estate of Doughty* is distinguishable from the present case. The will there involved was a holographic will, and in such a case, the presumption that the technical phrase "distribution of my estate" was used in its technical sense would not apply.

intent is expressed by the words utilized in paragraph "THIRD" of Mrs. Harmon's will. In *Farrell v. United States*, *supra*, the court denied a marital deduction for a spousal disposition containing the same survivorship condition as in the present case. While the court in *Farrell* did not consider whether the language used was ambiguous, the taxpayer's failure to raise the issue and the court's failure to consider it were quite likely due to the fact that the meaning of such a disposition *is* so clear in California. In several cases not involving the marital deduction, California State courts have interpreted dispositions very similar to the one here as creating an interest conditioned on surviving probate distribution, not just the testator's death. See *In re Estate of Germond*, *supra* (will provided for alternate gift in event that beneficiary died "prior to distribution to her of my estate"); *In re Jameson's Estate*, *supra* (will provided for alternate gift in event that beneficiary "does not survive distribution of my estate"); see also *In re Zuber's Estate*, 146 Cal. App. 2d 584, 304 P.2d 247 (Cal. Dist. Ct. App. 1956); *In re Hampe's Estate*, *supra*.

The petitioner has relied heavily on the court's reasoning in *Kellar v. Kasper*, 138 F. Supp. 738 (D.S.D. 1956), on remand from 217 F.2d 744 (8th Cir. 1954). In that case, the court applied South Dakota law to a testamentary disposition nearly identical to that of this case.[5] It determined first that the disposition to the surviving spouse vested immediately upon the testator's death because South Dakota law favors the early vesting of title. The court then turned to the question of whether the interest was subject to divestment, or termination, upon the occurrence of a subsequent event. After considering expert testimony from five eminent, South Dakota attorneys, the court concluded that the "divesting" language of the disposition, i.e., "if living at the time of the distribution of my estate," was ambiguous because it was fairly susceptible

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[5]The will in *Kellar v. Kasper*, 138 F. Supp. 738, 739 (D.S.D. 1956), provided, in pertinent part:

"Item 2. I give and bequeath to my wife, * * *, if living at the time of the Distribution of my estate, the sum of One Hundred Thousand Dollars * * *."

* * * * * * *

"Item 5. If living at time of the distribution of my estate, I give, devise and bequeath to my wife, * * *, one-third, and to my son, * * *, two-thirds of all the rest, residue and remainder of my property and estate * * *. If either my wife or my son dies prior to the distribution of my estate, * * * [the residue would pass to the survivor or other persons]."

of four different interpretations. Among such potential interpretations was "the 'distribution' effected by the law which occurs on the death of the testator." 138 F. Supp. at 743. Under South Dakota law, title to property, both real and personal, passes immediately to the heirs and beneficiaries upon the testator's death, subject only to the control of the county court for the purposes of administration, and a decree of distribution vests or grants no title, but merely releases the property from probate and confirms the title already passed to the heirs or beneficiaries. 138 F. Supp. at 741.

Having determined that the phrase "distribution of my estate" was ambiguous under South Dakota law, the court in *Kellar v. Kasper* resorted to extrinsic evidence of the circumstances surrounding the execution of the will in order to fathom the testator's intent. The testator, an "astute lawyer," himself drafted the will and revoked a prior will, which had given his wife a life estate in most of his property, for the sole purpose of taking advantage of the then recently enacted marital deduction. The court concluded that the testator intended by use of the phrase "distribution of my estate" to mean the passing of title to property which occurs at the time of a testator's death, and that consequently, the spouse acquired an indefeasibly vested interest at the time of the testator's death. Therefore, the marital deduction was allowed. 138 F. Supp. at 744.

The petitioner here also introduced expert testimony in an attempt to show that the disposition to Mr. Harmon was susceptible of several interpretations. Joan M. Sautter, a licensed attorney engaged in the practice of law in San Francisco, testified that the phrase "distribution of my estate" could mean (as in South Dakota) the passing of title to property which occurs at the time of the testator's death, subject only to probate administration.[6] It could also refer to

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[6] Cal. Prob. Code sec. 300 (West 1956). That section provides:

"When a person dies, the title to his property, real and personal, passes to the person to whom it is devised or bequeathed by his last will, or, in the absence of such disposition, to the persons who succeed to his estate as provided in Division 2 of this code; but all of his property shall be subject to the possession of the executor or administrator and to the control of the superior court for the purposes of administration, sale or other disposition under the provisions of Division 3 of this code, and shall be chargeable with the expenses of administering his estate, and the payment of his debts and the allowance to the family, except as otherwise provided in this code."

the recording of a community property order,[7] a decree of preliminary distribution,[8] a decree of final distribution,[9] or the recording of a decree of final distribution. Concluding that the phrase was ambiguous, Ms. Sautter stated that an interpretation meaning "at the time of my death" would be most consistent with California policy. She testified that such policy favored the early vesting of estates and the indefeasibility of vested estates. However, Ms. Sautter neither referred to nor explained how her position was consistent with the numerous California cases, cited above, which have held that the phrase "distribution of my estate" means entry of the decree of distribution. With the exception perhaps of *Estate of Doughty v. United States*, *supra*,[10] none of the courts in those cases found the phrase to be ambiguous.

Furthermore, while it is true that California, like most States, favors the early vesting of estates in order to prevent violations of the rule against perpetuities (see Cal. Prob. Code sec. 28 (West 1956); *In re Stanford's Estate*, 49 Cal. 2d 120, 315 P.2d 681, 683 (1957)), California also recognizes that testamentary dispositions may be subject to conditions precedent which will delay vesting until the occurrence of the contingency. See Cal. Prob. Code sec. 142 (West 1956). California also recognizes that a testamentary disposition may create a vested interest subject to a condition subsequent, the occurrence of which will terminate the interest. Cal. Prob. Code sec. 143 (West 1956). In fact, most of the California cases which have dealt with dispositions similar to the one involved here have found that the disposition created an unvested, contingent interest. See, e.g., *In re Estate of Germond*, *supra*; *In re Estate of Taylor*, *supra*; *In re Jameson's Estate*, *supra*. However, in any event, it is unnecessary to turn to the general guidelines of California policy where numerous California cases establish the meaning of the condition.[11]

The circumstances surrounding the execution of Mrs. Harmon's will are also distinguishable from those that existed in

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[7]Cal. Prob. Code sec. 655 (West Supp. 1984).
[8]Cal. Prob. Code sec. 1000 et seq. (West 1981).
[9]Cal. Prob. Code sec. 1020 et seq. (West 1981).
[10]See note 4 *supra*.
[11]We also observe that for purposes of the marital deduction, it is irrelevant whether the condition here is a condition precedent or a condition subsequent—in either event, it creates a nondeductible terminable interest.

Kellar v. Kasper, supra. In that case, the court was strongly influenced by the fact that the testator, a lawyer, drew up his new will, altering his estate plan, for the sole purpose of obtaining the marital deduction. The court presumed that, as an astute lawyer, he would understand the requirements for obtaining the deduction and would utilize language which he believed expressed that intention. In the present case, there is no evidence whatsoever that the decedent was seeking a marital deduction. Under a prior will, executed after she married Mr. Harmon, the decedent had left all of her estate to her son. She subsequently revoked that will and executed the will involved here, but even under this will, the bulk of her estate would still pass to her son. Mrs. Harmon altered her will in order to provide Mr. Harmon with a place to live, but that intent is in no way inconsistent with a desire to give her condominium and its contents to her son if Mr. Harmon were to die within the period of probate administration. Conceivably, Mrs. Harmon felt that the property should pass to whomever Mr. Harmon chose only if he lived long enough to use and enjoy it.

Because of other adjustments,

Decision will be entered under Rule 155.

JOHN K. JOHNSEN AND FRANCES JOHNSEN, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 12592–80. Filed March 4, 1985.

L, a limited partnership, was formed in April 1976 to develop an apartment project. P became a limited partner in July 1976. In our opinion in *Johnsen v. Commissioner*, 83 T.C. 103 (1984), we held that P was entitled to deduct his distributive share of a construction loan commitment fee, a management and guarantee fee, and a portion of a permanent loan commitment fee incurred by L during 1976. We also held that, under sec. 706(c)(2)(B), I.R.C. 1954, P must adjust his distributive share of such items to reflect the fact that he was not a member of L during its entire 1976 taxable year. However, we did not decide the method to be applied to account for P's varying interest. The Commissioner has the burden of proof with respect to the

varying interest issue because he raised the issue through affirmative allegations in the answer. *Held*:

1. Having proven that sec. 706(c)(2)(B) is applicable because P became a partner of L after its formation, the Commissioner's burden of proof extends only to applying a reasonable method of accounting for P's varying interest in the partnership. The Commissioner does not have the burden of proving and applying the method which is most favorable to P.

2. The proration method applied by the Commissioner is a reasonable method.

3. P has a right to use a more favorable method of accounting for his varying interest in the partnership, but he has the burden of proving the facts necessary for an interim closing of the partnership books as an alternative method; he has failed to carry such burden.

Donald W. Geerhart and *Donald J. Forman*, for the petitioners.

Sara M. Coe, for the respondent.

SUPPLEMENTAL OPINION

SIMPSON, *Judge*: On July 24, 1984, this Court filed its opinion (83 T.C. 103) determining the issues in this case and withheld entry of its decision for the purpose of permitting the parties to submit computations under Rule 155, Tax Court Rules of Practice and Procedure.[1] The parties submitted conflicting computations. On November 21, 1984, we entered our decision, adopting the Commissioner's computation that there was a deficiency of $2,698 in the income tax due from the petitioners for the taxable year 1976. The petitioners, John K. and Frances Johnsen, have moved to vacate the decision. We held a hearing on such motion in Washington, D.C., at which representatives for both parties appeared and presented their opposing arguments. Mr. Johnsen will sometimes be referred to as the petitioner.

In our prior opinion, we held that under section 212(1) or (2) of the Internal Revenue Code of 1954,[2] the petitioner was entitled, as a limited partner in Centre Square III, Ltd. (the limited partnership), to deduct his distributive share of a construction loan commitment fee, a portion of a permanent

[1] Any reference to a Rule is to the Tax Court Rules of Practice and Procedure.

[2] All statutory references are to the Internal Revenue Code of 1954 as in effect during the year in issue.

loan commitment fee,[3] and a $50,000 management and guarantee fee incurred by the limited partnership during 1976. Because the limited partnership was formed on April 11, 1976, and the petitioner did not acquire his limited partnership interest until July 19, 1976, we also held that, under section 706(c)(2)(B), the petitioner must adjust his distributive share of the limited partnership's deductible items to reflect his varying interest in the limited partnership. However, we did not decide what method was to be employed in adjusting the petitioner's distributive share.

The Commissioner bears the burden of proof with respect to the varying interest (or retroactive allocation of loss) issue because he raised it first in an affirmative allegation in his answer. Rule 142(a). In his post-trial brief, the Commissioner indicated that any reasonable method of allocating the limited partnership's deductions to the portion of the limited partnership's 1976 taxable year during which the petitioner was a partner would suffice. He utilized the proration method in his Rule 155 computation, calculating the petitioner's distributive share on the basis of his having been a limited partner for 165 days of the limited partnership's 263-day 1976 taxable year.[4]

In their motion to vacate, the petitioners argue that the Commissioner's burden of proof with respect to the varying interest issue extends to proving the method of accounting for Mr. Johnsen's varying interest which is most favorable to them. They maintain that the application of the interim closing of the books method results in no downward adjustment in his distributive share of the limited partnership's

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[3] The limited partnership claimed a deduction of $50,760 for fees charged for a permanent loan commitment and an extension of the permanent loan commitment. We disallowed a portion of the permanent loan commitment fee because such fee was excessive and, therefore, was not an ordinary and necessary expense.

[4] The Commissioner calculated the petitioner's distributive share of the limited partnership's deductible items as follows:

Partnership loss	$121,924
Petitioner's percentage interest in partnership	4.95%
Length of partnership's 1976 taxable year (4/11/76 - 12/31/76)	263 days
Length of petitioner's membership in 1976 (7/19/76 - 12/31/76)	165 days

4.95% × 165/263 × $121,924 = $3,786 (petitioner's share).

deductible items and that, therefore, it is the most favorable method.[5]

The proration method is the easier method to apply. It involves computing partnership income or loss at the end of the partnership year and allocating the yearend totals ratably over the year. The interim closing of the books method requires a closing of the partnership books as of the date of entry of the new partner and the computation of the various items of partnership income, gain, loss, deduction, and credit as of such date. See *Moore v. Commissioner*, 70 T.C. 1024, 1035 (1978); sec. 1.706–1(c)(2)(ii), Income Tax Regs. Thus, in order to effect an interim closing of the books in the present case, it is necessary to determine when the limited partnership, which utilized the accrual method of accounting, incurred the expenses for which a deduction has been allowed by our prior opinion.[6] The petitioners contend that the Commissioner bears the burden of proving when such expenses accrued and that unless the Commissioner can prove that they accrued before Mr. Johnsen became a limited partner, the Commissioner cannot apply the proration method because it does not provide the petitioners with the most favorable result.

The regulations under section 706(c)(2)(B) do not set forth methods for determining the distributive share of partners who are subject to the varying interest rule.[7] In *Richardson v.*

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[5] In their Rule 155 computation, the petitioners treated the limited partnership's deductible expenses as having accrued after the petitioner became a partner, and calculated his distributive share of such expenses under an interim closing of the books as follows:

4.95% × $121,924 = $6,035.24 (petitioner's share)

[6] Throughout this opinion, we shall refer to the commitment fees involved herein as deductible expenses, accruable on a single day for tax purposes, because such is the litigating stance of the parties in this case. See *Johnsen v. Commissioner*, 83 T.C. 103, 121–125 & n. 8 (1984). However, as will be explained more fully in the text, *infra*, the limited partnership treated the loan commitment fees as capital expenditures and calculated its deductions for such fees by amortizing them over the life of the commitments. We are aware that in other cases, loan commitment fees have been treated as capital expenditures amortizable over the life of the loan. See *Williams v. Commissioner*, T.C. Memo. 1981–643; *Francis v. Commissioner*, T.C. Memo. 1977–170; see also Rev. Rul. 81–160, 1981–1 C.B. 312, revoking Rev. Rul. 56–136, 1956–1 C.B. 92.

[7] The regulations under sec. 706(c)(2)(A) do provide rules when there is a sale or liquidation of an entire partnership interest. Sec. 1.706–1(c)(2)(ii), Income Tax Regs., provides that in cases of the sale, exchange, or liquidation of a partner's entire interest in a partnership, the partner may, "in order to avoid an interim closing of the partnership books," estimate his share of the partnership's distributive items "by taking his pro rata part of the amount of such items he would have included in his taxable income had he remained a partner until the end of the partnership taxable year. The proration may be based on the portion of the taxable year that has elapsed prior to the sale, exchange, or liquidation, or may be determined under any other method that is reasonable."

The congressional reports accompanying an amendment to sec. 706(c)(2)(B) made by the Tax

Commissioner, 76 T.C. 512, 526 (1981), affd. 693 F.2d 1189 (5th Cir. 1982), we stated that partnership income or loss may be allocated between the periods prior to and after the admission of a new partner using any reasonable method, including an interim closing of the books or an allocation of yearend totals of profit and loss ratably over the year. See also *Roccaforte v. Commissioner*, 77 T.C. 263, 289 (1981), revd. on another issue 708 F.2d 986 (5th Cir. 1983); *Marriott v. Commissioner*, 73 T.C. 1129, 1139 (1980); *Moore v. Commissioner*, 70 T.C. at 1035. If the petitioner elects the interim closing of the books method, he has the additional burden of establishing the date when each partnership item was paid or incurred. *Sartin v. United States*, 5 Cl. Ct. 172, 175–176 (1984); *Moore v. Commissioner*, 70 T.C. at 1036.

In the present case, we have already found that the limited partnership taxable year began on April 11, 1976, and that the petitioner did not become a member of such partnership until July 19, 1976. Hence, the Commissioner has already proven that the petitioner is subject to the varying interest provision of section 706(c)(2)(B). There is no basis in law for the petitioners' contention that, having proven that much, the Commissioner must also go on to prove and apply the allocation method most advantageous to the petitioners. Contrary to the petitioners' suggestion at the hearing on this motion, nothing contained in the committee reports accompanying the Tax Reform Act of 1976, Pub. L. 94–455, 90 Stat. 1520, supports the imposition of such burden. Both the House and the Senate reports on a clarifying amendment to section 706(c)(2)(B) added by such act state that regulations are to be adopted under section 706(c)(2)(B) which will provide for use of the same allocation methods as are currently applicable to section 706(c)(2)(A) situations. The reports explain:

> These rules will permit a partnership to choose the easier method of prorating items according to the portion of the year for which a partner was a partner or the more precise method of an interim closing of books (as if the year had closed) which, in some instances, will be more advantageous where most of the deductible expenses were paid or incurred upon or subsequent to the entry of the new partners to the partnership. [S. Rept. 94–938 (1976),

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Reform Act of 1976, Pub. L. 94–455, 90 Stat. 1547, direct that regulations be adopted "to apply the same alternative methods of computing allocations of income and loss to situations falling under section 706(c)(2)(B) as those now applicable to section 706(c)(2)(A) situations (sale or liquidation of an entire interest)." S. Rept. 94–938 (1976), 1976–3 C.B. (Vol. 3) 49, 136. See H. Rept. 94–658 (1975), 1976–3 C.B. (Vol. 2) 695, 816. Such regulations have not yet been adopted.

1976-3 C.B. (Vol. 3) 49, 136; H. Rept. 94-658 (1975), 1976-3 C.B. (Vol. 2) 695, 816-817.]

These reports in no way suggest that if the Commissioner bears the burden of proof on the varying interest issue, he must select the method most favorable to the petitioner. Section 706(c)(2)(B) requires only that a reasonable method be applied, and the proration method selected by the Commissioner is reasonable. *Sartin v. United States*, 5 Cl. Ct. at 178; *Richardson v. Commissioner*, 76 T.C. at 526; *Marriott v. Commissioner*, 73 T.C. at 1139; see sec. 1.706-1(c)(2)(ii), Income Tax Regs. Therefore, we hold that where the Commissioner bears the burden of proof with respect to the applicability of section 706(c)(2)(B), such burden does not extend beyond proving the facts necessary for the application of a reasonable method of allocation. Since the Commissioner here has proven the simple facts needed to apply the proration method, we find that he has met the burden of proof.

In cases where the Commissioner has raised the varying interest issue and applied an allocation method (usually proration) in the notice of deficiency, the petitioner has been afforded the opportunity to prove and apply another reasonable method at trial. See *Sartin v. United States*, *supra*; *Richardson v. Commissioner*, *supra*; *Moore v. Commissioner*, *supra*. We believe that the petitioners are entitled to a similar opportunity in this case. The petitioners maintain that all of the limited partnership's deductible expenses accrued sometime after Mr. Johnsen became a partner and, consequently, seek to apply the interim closing of the books method, as it will result, in such circumstances, in no downward adjustment of his distributive share. Upon an examination of the record, we hold that the petitioners have failed to prove that the bulk of the expenses accrued after Mr. Johnsen's entry into the partnership.

The expenses in question, construction and permanent loan commitment fees, and a management and guarantee fee, were obligations arising from separate contracts entered into between the limited partnership and Centre Square III (the general partnership). Very generally, the limited partnership was formed to acquire land and to construct and operate an apartment project called Centre Square III. The general partnership provided construction and permanent financing

and apartment management services to the limited partnership. See our findings of fact in *Johnsen v. Commissioner*, 83 T.C. at 104–114, for more details of the arrangement.

The construction loan commitment agreement was embodied in a letter issued by the general partnership to the limited partnership on April 15, 1976, as amended by a letter of April 20, 1976. The letter provided that the general partnership would make a construction loan of $3,171,200 at an interest rate of 2½ percent over the Chase Manhattan Bank's prime rate. The limited partnership agreed to pay a $28,200 "nonrefundable standby commitment fee" due at the time of its acceptance of the commitment. The construction loan commitment was effective until April 30, 1977, but was subsequently extended to August 31, 1977, by agreement dated August 17, 1976. The general partnership charged no additional fee for extending its construction loan commitment. On September 10, 1976, the limited partnership executed a nonrecourse construction loan note.

The permanent loan commitment was also contained in a letter, which was issued on April 14, 1976, and amended by a second letter of April 20, 1976. The commitment provided for a 30-year loan of $3,171,200 at an annual interest rate of 9¾ percent. The limited partnership agreed to pay a "nonrefundable standby commitment fee" of $84,600 due at the time of the commitment letter's acceptance (acceptance being required by May 15, 1976). In August 1976, the general partnership extended its permanent loan commitment until August 31, 1977; for the extension, the limited partnership paid a fee of $11,280. The limited partnership executed a nonrecourse promissory note and a deed of trust reflecting the terms of the permanent loan commitment in October 1977.

The limited partnership amortized the $28,200 construction loan commitment fee and the $84,600 permanent loan commitment fee over the life of each commitment. According to its accountant's workpapers, the limited partnership treated both commitments as having commenced on April 20, 1976, and using a half-month convention, amortized each commitment over a period beginning on May 1, 1976. Thus, the limited partnership deducted amortization for 8 months in 1976. The $11,280 permanent loan commitment extension fee was similarly amortized over the life of the extension. Such fee was

treated as having been incurred on August 17, 1976, and applying the half-month convention, was amortized over a period commencing on September 1, 1976. In our prior opinion, we determined that the limited partnership was entitled to deduct in 1976 all of the $15,667 claimed on its return as amortization of the construction commitment fee, and $20,901 of the $50,760 claimed as amortization of the permanent commitment fee and extension fee.[8]

The limited partnership's $50,000 management and guarantee fee deduction, which we determined to be allowable in our earlier opinion, arose under a written management agreement executed by the general and limited partnerships on April 11, 1976. Under the terms of the agreement, the general partnership assumed total responsibility for the leasing, management, and administration of Centre Square III. The general partnership also guaranteed that Centre Square III would operate without cash flow deficits through December 31, 1980. For its services and the guarantee, the general partnership would receive 5 percent of the gross receipts generated by Centre Square III and an additional $50,000 each year for 1976 through 1980. During 1976, there were no gross receipts, and the percentage fee yielded no payment. However, the fixed $50,000 fee was paid in that year and was primarily intended to compensate the general partnership for management activities. According to its accountant's workpapers, the limited partnership viewed the management fee as having accrued on April 11, 1976, the day on which the management agreement was executed.

The petitioners now argue that none of the above expenses were incurred until after Mr. Johnsen became a partner in July 1976, despite the fact that the limited partnership treated all (with the exception of the extension fee) as having been incurred in April 1976 and calculated its amortization deductions from such time. Under the accrual method of accounting, an expense is deductible in the taxable year in which "all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy." Sec. 1.461–1(a)(2), Income Tax Regs.; see *United States v. Anderson*, 269 U.S. 422, 442 (1926). The petitioners do

[8] See notes 3 & 6, *supra*.

not contest the certainty of the amounts of the expenses in question, but do assert that the fact of the liability was subject to a substantial contingency, the rezoning of the land on which the apartment project was to be built from commercial to residential.[9] This contingency is not express in any of the agreements between the general partnership and the limited partnership. Nevertheless, the petitioners contend that such a condition to the limited partnership's obligation to pay the fees in question is inferable if the management and loan commitment agreements are viewed in the larger context of the apartment project venture. Specifically, they rely upon the general partnership's warranty, contained in the sales agreement under which it agreed to sell the apartment project to the limited partnership, that the project would comply with zoning ordinances. The sales agreement was executed on April 11, 1976, at about the same time as the management and loan commitment agreements, and also referred to such agreements.

The petitioners' argument is unpersuasive for a number of reasons. First, none of the agreements between the partnerships, including the sales agreement, was expressly made conditional upon the acquisition of rezoning. Furthermore, there is no evidence that, at the time they executed the agreements, the parties feared that rezoning would not be obtained. At such time, rezoning had already been unanimously approved by the local zoning commission. The parties' confidence that the rezoning would occur is indicated by the construction loan commitment agreement, which provided that the general partnership would be ready to make its first loan advance on May 1, 1976. Only after the execution of the contracts did rezoning become a potential problem. Neighborhood opposition to the project caused the city council to reject the rezoning application, but without prejudice to its resubmission. In September 1976, the city council eventually approved

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[9] The petitioners have also contended that, under the terms of the private offering memorandum issued to prospective investors in the limited partnership, all invested funds would be returned if 40 percent of the limited partnership units were not sold prior to closing on the sale of the apartment project to the limited partnership. The 40-percent subscription requirement was said to be a contingency delaying accrual of the expenses at issue until the closing in September 1976. However, at the hearing, the petitioners conceded that the record indicates that such contingency was eliminated by late May, when the 40-percent requirement was met. Therefore, we shall treat this second contingency argument as abandoned and shall not discuss it further.

the zoning change. Although the neighborhood opposition delayed the start of construction until September, the petitioners have failed to prove that the eventual outcome of the rezoning application was ever in substantial doubt. The limited partnership itself must not have viewed rezoning as a condition to its liability, since it treated the expenses as incurred in May, and not in September.

The petitioners' argument also fails to consider the nature of standby loan commitment fees. Such fees are paid to the lender in return for the lender's present promise to make a loan of a stated amount at a stated interest rate over a stated period. See Neuman & Elfman, "The Tax Treatment of Loan Commitment Fees after Rev. Ruls. 81–160 and 81–161," 60 Taxes 394, 395 (1982); G. Robinson, Federal Income Taxation of Real Estate, pars. 7.02, 8.05[2][b] (1984). The construction and permanent loan commitment fees in the present case were nonrefundable and due upon acceptance of the commitment. The limited partnership's liability to pay the fees became fixed upon acceptance. It is significant that the parties to the commitment agreements executed extensions thereof in August 1976 when the start of construction was delayed by the zoning problem. An additional fee was also charged for the extension of the permanent loan commitment.

We can only conclude that the petitioners have failed to prove that the limited partnership's deductible expenses, with the exception of the permanent loan commitment extension fee,[10] accrued after Mr. Johnsen entered the partnership. Consequently, we hold that the petitioners have not proven the facts necessary for application of the interim closing of the books method, and their motion to vacate our decision will be denied.

Before we close, we must address one last argument. The petitioners assert that the record suggests, if it does not establish, that the limited partnership did not pay the management and loan commitment fees until September 1976. They maintain that if the limited partnership had utilized the cash method of accounting, Mr. Johnsen would be entitled to an unreduced share of the partnership's losses under the interim closing of the books method. See *Richardson v.*

[10]The permanent loan commitment extension fee accrued after the petitioner became a partner because the extension was not agreed to until August 1976.

Commissioner, 76 T.C. at 527. According to the petitioners, the result should be no different because the limited partnership in the present case used the accrual method, since Mr. Johnsen's funds were used to discharge the limited partnership's obligations.

We disagree. In *Richardson*, the Commissioner contended that new members of a cash method partnership could not be allocated losses based on an interim closing of the books unless the partnership's expenses were incurred as well as paid after their entry. We rejected the Commissioner's contention, observing that the deductibility and timing of a deduction is determined at the partnership level and by the method of accounting utilized by the partnership. 76 T.C. at 527; see W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners, par. 9.02[1], at 9–5 to 9–7 (1977). We held that a share of partnership expenses incurred before but paid after the entry of the new partners could be allocated to them because their funds were used to pay the expenses and caused such expenses to become deductible. 76 T.C. at 527. Such is not the case here. The limited partnership utilized the accrual method in calculating its deductions, and since the bulk of the partnership's deductions were incurred and deductible before Mr. Johnsen became a partner, a retroactive allocation of tax losses would result if we pretended that the partnership was on the cash method for purposes of an interim closing of the partnership books.

We also observe that Congress has significantly amended section 706(c)(2)(B) since our decision in *Richardson*. Sec. 72, Tax Reform Act of 1984, Pub. L. 98–369, 98 Stat. 589. Effective for amounts attributable to periods after March 31, 1984, the amendment essentially requires that, for purposes of section 706(c)(2)(B), cash method partnerships must utilize the accrual method with respect to certain expenditures, and that such items must be allocated ratably among old and new partners. Although not applicable to the case before us, the amendment supports our position that an interim closing of the books based on the date of payment rather than accrual would result in the retroactive allocation of losses to Mr. Johnsen.

Petitioners' motion to vacate the decision will be denied.

ROY C. DERKSEN, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 35096–84. Filed March 7, 1985.

Rules 30 and 41(a), Tax Court Rules of Practice and Procedure.—Respondent filed a motion to dismiss for failure to state a claim; subsequently, petitioner sought leave to file an amended petition. *Held*: Leave to file amended petition is not necessary where no responsive pleading has been filed; motion to dismiss is not a responsive pleading. Rules 41(a) and 30, Tax Court Rules of Practice and Procedure. Amended petition relates back to time of filing original petition and will be considered in light of the motion to dismiss. Amended petition fails to state a claim upon which relief can be granted and is dismissed. Damages are awarded to the United States under sec. 6673, I.R.C. 1954.

Roy C. Derksen, pro se.
Mark D. Petersen, for the respondent.

OPINION

FEATHERSTON, *Judge*: This case was assigned to Special Trial Judge Helen A. Buckley pursuant to the provisions of section 7456(d) and Rule 180.[1] The Court agrees with and adopts her opinion which is set forth below.

OPINION OF THE SPECIAL TRIAL JUDGE

BUCKLEY, *Special Trial Judge*: This case is before the Court on respondent's motion pursuant to Rule 40 to dismiss for failure to state a claim upon which relief can be granted. Additionally, we consider petitioner's motion for leave to file an amended petition.

Petitioner resided in Brandon, Wisconsin, at the time the petition was filed.

Respondent determined deficiencies in petitioner's Federal income taxes, self-employment taxes, and additions to tax as follows:

[1] Section references are to the Internal Revenue Code of 1954 as amended, unless otherwise indicated. Rule references are to the Tax Court Rules of Practice and Procedure.

Year	Income tax	Self-employment tax	Additions to tax		
			Sec. 6651(a)	Sec. 6653(a)	Sec. 6654
1980	$5,815	$1,833	$1,912	$382	$488
1981	6,462	2,259	2,180	[2]436	669
1982	6,444	2,384	2,207	[3]441	860

The determination was based upon unreported taxable income from self-employment for the 3 years under consideration in the amounts of $21,634, $23,287, and $24,501. Respondent also determined for all the years in question that petitioner failed to file returns; that the underpayments of taxes were due to petitioner's negligence or intentional disregard of rules or regulations; and that petitioner failed to pay estimated income taxes.

Petitioner filed voluminous documents with this Court as his response to the deficiency notice. These were treated as his petition. His petition, consisting of about 90 pages of mimeographed material is generally incomprehensible, but it is possible to discern that petitioner makes the following contentions:

(1) There is no jurisdiction of this Court over petitioner.

(2) Petitioner is immune from taxes.

(3) Petitioner is not required to set forth his grounds supporting his position.

(4) Petitioner has never submitted to or become subject to the jurisdiction of Congress or the Internal Revenue Service in any matter related to or authorizing Federal taxes.

(5) Petitioner has not volunteered to file a return or provide information and is not required to do so.

(6) The Sixteenth Amendment to the Constitution is only applicable to corporations and quasi-corporate entities.

(7) Petitioner is not a taxpayer.

(8) Petitioner does not intend to have a social security number or to collect social security benefits, and he resigns from social security programs.

We take judicial notice that we have previously received in other cases documents substantially similar to those filed herein. Petitioner failed to raise any justiciable issues of law or fact. This petition, therefore, fails to state a claim upon which

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[2]Together with 50 percent of the interest due on $8,721 pursuant to sec. 6653(a)(2).
[3]Together with 50 percent of the interest due on $8,828 pursuant to sec. 6653(a)(2).

relief can be granted. *Rowlee v. Commissioner*, 80 T.C. 1111 (1983). We will not expend the resources and energy of this Court to respond to each and every frivolous allegation of petitioner, as we have treated them time and time again in regard to other tax protesters. It is enough to state that they are completely without merit. *McCoy v. Commissioner*, 76 T.C. 1027, 1029–1030 (1981), affd. 696 F.2d 1234 (9th Cir. 1983).

After the filing of respondent's motion to dismiss, petitioner forwarded to this Court documents entitled "Amended Petition," "Motion for Leave to File Amended Petition," as well as one entitled "Objection to Motion to Dismiss for Failing to State a Claim." The objection states only "Respondent received an affidavit with the original Petition stating that Petitioner had no income for the years involved."[4]

We first deal with petitioner's motion for leave to file an amended petition. We grant that motion, although in our view it is not necessary to do so since petitioner has a right under our Rules to file the amended petition without seeking leave of the Court. Rule 41(a) provides that "A party may amend his pleading once as a matter of course at any time before a responsive pleading is served." Petitioner has not heretofore filed an amended petition. Further, respondent's motion to dismiss does not represent a responsive pleading. Rule 30. Rule 41(a) clearly states that under these circumstances, petitioner has a right to file his amended pleading, even without leave of this Court.[5] Our Rule 41(a) is derived to a substantial extent from rule 15(a), Federal Rules of Civil Procedure (Notes to Rule 41(a), 60 T.C. 1059, at 1089) and is intended to reflect a liberal attitude in favor of pleading amendments. Many cases in which the right to file an amended complaint under the Federal Rules was considered have held that a motion to dismiss is not a responsive pleading within the meaning of rule 15 of the Federal Rules of Civil Procedure. See *Barksdale v. King*, 699 F.2d 744 (5th Cir. 1983); *Thomas v. Pate*, 493 F.2d 151, 162 (7th Cir. 1974), cert. denied 419 U.S. 879 (1974);

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[4] The written objection by petitioner is considered but it in no manner sets forth the elements of a claim upon which relief can be accorded petitioner.

[5] We have, on numerous occasions, stated that our Rules of practice and our orders mean exactly what they say. *Rosenfeld v. Commissioner*, 82 T.C. 105, 111 (1984); *Odend'hal v. Commissioner*, 75 T.C. 400, 404 (1980), affd. 748 F.2d 908 (4th Cir. 1984); *Branerton Corp. v. Commissioner*, 61 T.C. 691, 692 (1974).

Fuhrer v. Fuhrer, 292 F.2d 140, 142 (7th Cir. 1961);[6] *Peterson Steels v. Seidmon*, 188 F.2d 193 (7th Cir. 1951). These cases provide firm support for our holding in this regard. Thus, leave is granted to file the amended petition.[7]

Having determined that the amended petition should be filed, we next turn our consideration to the impact of petitioner's amended petition on respondent's motion to dismiss for failure to state a claim. One possibility would be to deny respondent's motion as moot since it was filed in relation to the original petition. To do so under the circumstances of this case would be to exalt form over substance. Our Rules provide that they shall be construed to secure the just, speedy, and inexpensive determination of every case. Rule 1(b). See, e.g., *Hicks Nurseries v. Commissioner*, 62 T.C. 138 (1974). In order to meet the Rules' requirement of a speedy, just, and inexpensive determination in this matter, we will consider the motion to dismiss in regard to the amended petition.

We have, in the past, considered motions to dismiss, filed prior to the filing of an amended petition, in light of the facts alleged in the amended petition. Thus, in *Estate of Peterson v. Commissioner*, 45 T.C. 497 (1966), respondent filed a motion to dismiss for lack of jurisdiction in regard to an estate under then Rules 6 and 7 on the ground that no fiduciary or personal representative of the estate had authorized the bringing of the suit on behalf of the estate. Subsequent to respondent's motion, a temporary administratrix was appointed and leave to file an amended petition was granted. We then considered respondent's motion to dismiss in relation to the amended petition and denied it. There have been similar holdings under the Federal Rules. See *Barksdale v. King*, *supra*, where a

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[6] *Fuhrer v. Fuhrer*, 292 F.2d 140 (7th Cir. 1964), held that the plaintiff had an absolute right to amend the complaint even after the issuance of an order granting the defendant's motion to dismiss. We need not consider that question here since the motion for leave to file an amended petition was received prior to action on the motion to dismiss.

[7] We do not address the situation where an amended pleading has already been filed and leave of the Court is requested to file further amendments. There, even though we respect the underlying principle of the rule which is tolerant towards amendments, we note the Supreme Court has opined in *Foman v. Davis*, 371 U.S. 178, 182 (1962), that such leave to amend may be inappropriate where there is "any apparent or declared reason—such as undue delay, bad faith or dilatory motive on the part of the movant, repeated failure to cure deficiencies by amendments previously allowed, undue prejudice to the opposing party by virtue of allowance of the amendment, futility of amendment, etc."—for denying it. If to allow the amended pleading would be futile, e.g., for its failure to state a claim upon which relief can be afforded, it is within the discretion of the court to refuse to grant leave to file the amendment. See *Jafree v. Barber*, 689 F.2d 640, 644 (7th Cir. 1982), *Klamath-Lake Pharm. v. Klamath Med. Serv. Bureau*, 701 F.2d 1276, 1293 (9th Cir. 1983).

motion to dismiss for failure to state a claim filed prior to the filing of an amended complaint was denied not because it was moot, but because the amended complaint in fact did state a claim. See also *Peterson Steels v. Seidmon*, *supra*, where the Seventh Circuit, in reversing the District Court's denial of leave to file an amended complaint, concluded that the amended complaint did state a cause of action and remanded the action.

Since the amended petition is subject to the same scrutiny to ascertain whether it states a claim as the original petition, and since it relates back to the time of filing the original, Rule 41(d),[6] we consider the motion to dismiss, based on the authority of the foregoing cases, in relation to the amended petition. We have found that the original petition fails to state a claim upon which relief can be accorded. We find the amended petition similarly lacking.

The amended petition states, as to all 3 years at issue, that respondent has erroneously and wrongfully included in gross income the sums set forth in the deficiency determination, and has erroneously and wrongfully determined the various additions to tax. It goes on to state that petitioner is "an unenfranchise [sic] free man at Common Law," not a "juristic person in equity," that petitioner has no obligations under the Internal Revenue Code for the years in question, that the notice of deficiency gives the wrong filing status for petitioner, that petitioner did not self-assess himself so no deficiency can exist, that respondent has no evidence that petitioner shelled corn as alleged in the notice and even if he did, it would have been an equal exchange of service for compensation and no profit or gain would have accrued to petitioner.

The amended petition does not contain any allegations whatsoever as to the receipt of unreported income from corn shelling, which is the basis of the deficiency notice. Rule 34(b) requires that a petition contain—

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[6] Rule 41(d) provides:

"When an amendment of a pleading is permitted, it shall relate back to the time of filing of that pleading, unless the Court shall order otherwise either on motion of a party or on its own initiative."

We do not order otherwise in this case.

(4) Clear and concise assignments of each and every error which the petitioner alleges to have been committed by the Commissioner in the determination of the deficiency or liability. The assignments of error shall include issues in respect of which the burden of proof is on the Commissioner. Any issue not raised in the assignment of errors shall be deemed to be conceded. Each assignment of error shall be separately lettered.

(5) Clear and concise lettered statements of the facts on which petitioner bases the assignments of error, except with respect to those assignments of error as to which the burden of proof is on the Commissioner.

Petitioner, who bears the burden of proof in this matter (*Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a)), has failed completely to allege any justiciable assignments of error of either law or of fact. He is considered, under Rule 34(b)(4), to have conceded such issues.

A portion of the deficiency for each year relates to taxes under the provisions of section 1401 of the Code. That section imposes a tax upon net earnings from self-employment for social security purposes. We note that petitioner's only claim in this regard is that he wishes to resign from the social security system. There are some specific exemptions from the tax but the desire not to be a part of the social security system, standing alone, is not one of them. See *Templeton v. Commissioner*, T.C. Memo. 1982–456, affd. 719 F.2d 1408 (7th Cir. 1983). Petitioner has alleged no bases for exemption and we particularly note that he has not denied that he was self-employed. His position is without merit and he has failed to state a claim upon which relief can be afforded.

This Court, as well as every court which has considered the matters set forth in petitioner's amended complaint, has rejected them entirely. We stated in *McCoy v. Commissioner*, 76 T.C. at 1029–1030, that:

> The time has arrived when the Court should deal summarily and decisively with such cases without engaging in scholarly discussion of the issues or attempting to soothe the feelings of the petitioners by referring to the supposed "sincerity" of their wildly espoused positions.

We intend to follow *McCoy* in this regard. Petitioner's allegations are frivolous and completely without merit. See *Schiff v. Commissioner*, 751 F.2d 116 (2d Cir. 1984), affg. T.C. Memo. 1984–223; *Granzow v. Commissioner*, 739 F.2d 265 (7th Cir. 1984); *Lonsdale v. Commissioner*, 661 F.2d 71 (5th Cir. 1981); *Rowlee v. Commissioner*, 80 T.C. 1111 (1983); *Reading v.*

Commissioner, 70 T.C. 730 (1978), aff'd. 614 F.2d 159 (8th Cir. 1980). Respondent's motion to dismiss is granted.

We now consider, on our own motion, whether damages should be awarded to the United States under the provisions of section 6673 of the Code. That section provides that whenever it appears to this Court that proceedings before it have been instituted or maintained by the taxpayer primarily for delay or that the taxpayer's position in such proceedings is frivolous or groundless, damages in an amount not in excess of $5,000 shall be awarded to the United States. We find petitioner's petition and amended petition, as well as his objection to respondent's motion to dismiss, to be frivolous and groundless.[9] We believe that they were filed only for purposes of delay. Accordingly, damages in the amount of $5,000 are awarded to the United States.

An appropriate order and decision will be entered.

THE UNION CENTRAL LIFE INSURANCE COMPANY, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 2094–78. Filed March 11, 1985.

The Court of Appeals held that in order to deduct general expenses from gross investment income under sec. 804(c)(1), I.R.C. 1954, they must be directly related to the production of investment income. *Held*, petitioner may not deduct any portion of the Ohio Franchise Tax because such tax was not directly related to the production of investment income.

William R. Seaman, Jerry L. Cowan, and *Thomas C. Rink*, for the petitioner.

Conley G. Wilkerson, for the respondent.

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[9] In respondent's motion to dismiss, he cited the opinion of this Court in *Rowlee v. Commissioner*, 80 T.C. 1111 (1983), and attached as Exhibit B a Memorandum Sur Order of this Court in *Kernodle v. Commissioner*, docket No. 8942–84, in which arguments the same as those of petitioner were held to be meritless. Petitioner nevertheless has continued on his path of tax protest in his amended petition.

SUPPLEMENTAL OPINION

WILES, *Judge*: The Court of Appeals for the Sixth Circuit remanded this case for us to determine whether the payments of Ohio franchise taxes by petitioner during 1972, 1973, and 1974 were directly related to the production of investment income.

The issue in this case is legal. However, to the extent necessary we find the facts to be as set forth in the findings of fact in our opinion filed in *Union Central Life Insurance Co. v. Commissioner*, 77 T.C. 845 (1981).

We are concerned herein with the calculation of petitioner's investment yield pursuant to section 804(c).[1] To the extent relevant, investment yield is defined as gross investment income less investment expenses and general expenses which are in part assigned to or included in investment expenses. Sec. 804(c)(1); sec. 1.804–4(b)(1)(ii), Income Tax Regs. The definition of investment expenses and general expenses is not provided by statute but may be found in the regulations under section 804. Generally, investment expenses are payments made for the exclusive benefit of the investment department, whereas general expenses are payments made for the benefit of more than one department, but which can be allocated among such departments. Sec. 1.804–4(b)(1)(i) and (ii), Income Tax Regs.; *Union Central Life Insurance Co. v. Commissioner*, 720 F. 2d 420, 423 (6th Cir. 1983).

In analyzing the standard to be applied in determining whether investment and general expenses are deductible, the Sixth Circuit stated that:

> It is undisputed that investment expenses must be directly and entirely related to the production of investment income. *Commissioner of Internal Revenue v. Volunteer State Life Insurance Company*, 110 F.2d 879, 882 (6th Cir. 1940), cert. denied, 310 U.S. 636, 60 S. Ct. 1080, 84 L. Ed. 2d 1405 (1940); *New World Life Insurance Company v. United States*, 26 F. Supp. 444, 458, 88 Ct. Cl. 405 (1939), affd. 311 U.S. 620, 61 S. Ct. 314, 85 L. Ed. 388 (1940). The Tax Court held that because § 804(c)(1) creates two categories of deductible expenses, i.e., investment expenses and general expenses, the criteria which

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[1] All section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

The Tax Reform Act of 1984, Pub. L. 98–369, 98 Stat. 494, repealed the law governing life insurance company taxation here under consideration and replaced it with an entirely new set of rules for tax years beginning after Dec. 31, 1983.

apply to the former do not apply to the latter. Hence, the court stated that general expenses need not meet the directness requirement.

This conclusion was error. The Court of Claims has held that general expenses are deductible as investment expenses if the former can:

With some degree of reasonableness, be said to have some *direct* relationship to the investment department and also to be reasonably susceptible of division and assignment in part to the different departments of the business. [Emphasis supplied.]

New World Life, 26 F. Supp. at 459. Moreover, this court in *Volunteer State Life* held that portions of general expenses which are assigned to or included in investment expenses must be directly and entirely related to investment department operations. 110 F.2d at 882. We therefore hold that for general expenses to be deductible under § 804(c)(1), they must be directly related to the production of investment income.

[720 F.2d 420, 423 (6th Cir. 1983); fn. ref. omitted.]

Respondent's primary contention is that petitioner's payment of the Ohio franchise taxes was not directly related to the production of investment income because the payments did not create or produce any amount of gross investment income.

Petitioner, on the other hand, maintains that section 1.804–4(b)(1)(ii), Income Tax Regs., allows a deduction for general expenses "properly allocable" to the investment department, and that once a general expense is "properly allocated" to the investment department the portion so allocated is proximately and primarily related to the investment department and therefore "directly" related to the production of investment income. Petitioner further maintains that the Ohio franchise tax is directly related to the production of investment income because it is a general tax on the privilege of doing business within the State. Finally, petitioner maintains that during the years in issue, the tax was imposed on petitioner's surplus which consisted entirely of investment income and therefore the tax was directly related to the production of that investment income.

Petitioner's first argument must be rejected because it merely substitutes the term "properly allocable" for the "directly related" standard adopted by the Sixth Circuit. Petitioner appears to contend that the act of "properly allocating" general expenses to the investment department automatically provides the necessary direct relationship between the expense and the production of investment income.

However, the clear implication from the Sixth Circuit's opinion is that a general expense must bear a direct relationship to the production of investment income before it can be allocated to the investment department. Absent the requisite direct relationship no portion of a general expense may be allocated to the investment department and deducted as an investment expense.

Petitioner's second argument that the tax is deductible because it is a general tax on the privilege of conducting business within the State must also be rejected. In *Liberty Life Insurance Co. v. United States*, 594 F.2d 21 (4th Cir. 1979), cert. denied 444 U.S. 838 (1979), cited by the Sixth Circuit as possibly supporting petitioner's position (720 F.2d 420, 422 (6th Cir. 1983)), the Fourth Circuit stated in dicta that a tax imposed on the privilege of transacting business within a State "might be apportioned to the investment department" and deductible as an investment expense. *Liberty Life Insurance Co. v. United States, supra* at 24. The tax involved in *Liberty Life* was a South Carolina license fee imposed upon the premium receipts of domestic life insurance companies which was subject to a maximum rate of 5 percent of net income from all sources. The taxpayer argued that because it paid the maximum amount, the tax was imposed on its net income, including investment income, and a portion was therefore properly allocable to the investment department. The Fourth Circuit held that no part of the license fee was allocable to investment expenses because the South Carolina statute clearly intended to tax premium income rather than investment income, and the cap of 5 percent of net income was merely a method of both limiting the amount of tax and providing a simple way for calculating the tax due. *Liberty Life Insurance Co. v. United States, supra* at 23.

In *Liberty Life*, the Fourth Circuit did not specifically require that the tax, as a general expense, be directly related to the production of investment income. Moreover, the Fourth Circuit found that the tax was not deductible because it was intended to be a tax on premium income.

More significantly, payment of the Ohio franchise tax does not per se produce investment income, it merely permits petitioner to engage in the business of conducting a life insurance company operation in Ohio. Expenses incurred in

the acquisition of the right to engage in an activity are entirely distinct from expenses incurred in the actual production of income earned by engaging in the permitted activity. The former merely permit a given activity while the latter actually produce income from the activity. Since the Sixth Circuit held that general expenses are deductible only when they directly relate to the production of investment income, no portion of the Ohio franchise tax may be deducted as an investment expense because payment of the tax simply does not produce investment income.

Petitioner argues that there is nothing in the regulations that requires a portion of a general expense to directly create or produce investment income in order to be deductible as an investment expense. As examples, petitioner cites section 1.804–4(b)(1)(ii), Income Tax Regs., which provides that real estate taxes, depreciation, and other expenses attributable to office space owned by the company and utilized by it in connection with its investment function may be deductible as general expenses assigned to or included in investment expenses. Petitioner maintains that none of these expenses directly create or produce investment income even though a portion of such expenses may be "attributable to" the investment department and "properly allocable" to gross investment income within the meaning of the regulations. We disagree with petitioner. The Sixth Circuit imposes the requirement that general expenses must be directly related to the production of investment income before they may be attributed to the investment department and "properly allocable" to gross investment income. While real estate taxes, depreciation, and other expenses attributable to office space used by the investment department may not literally produce investment income, these expenses are directly attributable to assets "utilized by [petitioner] in connection with its investment function" (sec. 1.804–4(b)(1)(ii), Income Tax Regs.), and in this manner are directly related to the actual production of investment income. The franchise tax, in contrast, is merely permissive and is not per se *utilized* in connection with petitioner's investment function nor is it directly attributable to assets so utilized. Sec. 1.804–4(b)(1)(ii), Income Tax Regs.

Finally, petitioner's argument that the franchise tax is deductible because it is effectively levied on investment

income in the form of surplus must be rejected. The Ohio franchise is imposed on the lesser of: (1) Capital and surplus; or (2) 8⅓ times the gross premiums received on risks in Ohio, less various deductions not relevant herein. Clearly, the tax is imposed directly on surplus or gross premiums, and only indirectly, or not at all, on investment income. In most cases, investment income may form a part of surplus but once investment income has been filtered through the calculations necessary to determine surplus there is no guarantee of a direct relationship between the amount of investment income and the amount of surplus.[2] We believe that we correctly stated the relationship between the tax and petitioner's investment income in our original opinion when we noted that "although the tax was not directly and exclusively related to investment income, it was certainly attributable to the investment part of petitioner's business." *Union Central Life Insurance Co. v. Commissioner*, 77 T.C. at 861. Because the Sixth Circuit requires a direct relationship between a general expense and the production of investment income, we are constrained to hold that petitioner may not deduct any portion of the Ohio franchise tax which is merely attributable to its investment income.[3]

To reflect the foregoing,

Decision will be entered for the respondent.

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[1] In petitioner's case, the Ohio franchise tax statute, Ohio Rev. Code Ann. sec. 5725.18 (Page 1982), imposes a tax on the privilege of being an insurance company on the following base:

(A) The capital and surplus of a domestic insurance company having capital divided into shares, or the surplus of a domestic insurance company not having capital divided into shares, at the value thereof reported by the company in its annual statement for the preceding year filed with and approved by the superintendent of insurance setting forth the admitted and nonadmitted assets and the liabilities of the company, including in such liabilities:

(1) The reserve and unearned premium liabilities computed as provided by law, the same being the amount of debts of an insurance company because of its outstanding policies in gross;

(2) Amounts set apart for the payment of dividends to policyholders, and all actual liabilities set forth in the annual statement; * * *

[2] We expressly do not decide whether the test which the Sixth Circuit has directed us to apply would be applied by this Court in cases appealable to other circuits.

SOUTHERN PACIFIC TRANSPORTATION COMPANY, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 7501–72. Filed March 12, 1985.

Old SP was the common parent of an affiliated group which filed consolidated Federal income tax returns for the years at issue, calendar years 1962 through 1965. During 1969, but prior to Nov. 26, 1969, new SP and its wholly owned subsidiary, SPTC, were formed. On Nov. 26, 1969, a merger occurred in which (1) SPTC acquired all the assets of old SP, (2) the shareholders of old SP became the sole shareholders of new SP, (3) old SP was dissolved, and (4) new SP assumed the name of old SP. Contractually under the merger agreement as well as legally under State law, SPTC as successor in interest in old SP, became primarily liable for the obligations of old SP.

On June 28, 1972, respondent mailed a statutory notice to new SP which determined deficiencies against the affiliated group for the years 1962 through 1965. On the same date, respondent mailed a statutory notice of transferee liability of SPTC. The notice determined liability for deficiencies in the consolidated income tax liabilities of the old SP affiliated group for the years 1962–65 against SPTC, as transferee of old SP.

SPTC filed a motion to dismiss on the ground that it is primarily liable under State law for all pre-merger deficiencies determined against the affiliated group for the years 1962 through 1965 and that the notice of transferee liability was therefore invalid. SPTC filed a motion in the alternative to substitute itself as petitioner in its capacity as the surviving corporation in merger with and as successor in interest to old SP, in its own behalf and as agent for those corporations which were members of the old SP affiliated group for the taxable years 1962 through 1965.

Held: That SPTC is liable as a transferee at law for the liabilities of old SP because SPTC contractually assumed the obligations of old SP under the merger agreement, regardless of the fact that SPTC is primarily liable under State law. Respondent's notice of transferee liability was "proper, and therefore SPTC's motion to dismiss and SPTC's alternative motions are denied.

Arnold I. Weber, Alan S. Beinhorn, and *William E. Saul*, for the petitioner.

Peter D. Bakutes, James Booher, Vernon R. Balmes, Bernard Plamer, Lawrence G. Becker, and *Randall G. Dick*, for the respondent.

OPINION

Background

JACOBS, *Judge*:* Petitioner herein is Southern Pacific Transportation Co. ("Transportation"), in its capacity as transferee of the assets of Southern Pacific Co. ("former Southern Pacific"), the common parent of an affiliated group of corporations.[1] This case is before the Court on Transportation's

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*By order of the Chief Judge, this case was reassigned from Judge William M. Drennen to Judge Julian I. Jacobs for disposition.

[1] In the statutory notice of transferee liability, respondent proposed assessment against Southern Pacific Transportation Co., as a transferee, of the liabilities of the former Southern Pacific Co. affiliated group which, during the years at issue, consisted of the following corporations:

Southern Pacific Co. (former Southern Pacific)
Holton Inter-Urban Railway Co.
Inter-California Railway Co. (liquidated effective 7/25/66)
Los Angeles Union Terminal, Inc.
Nacozari Railroad Co. (liquidated effective 5/5/66)
Northwestern Pacific Railroad Co.
Pacific Electric Railway Co. (merged into former Southern Pacific, 8/13/65)
Pacific Petroleum Pipe Lines, Inc.
Petaluma & Santa Rosa Railroad Co.
San Diego & Arizona Eastern Railway Co.
Southern Pacific Equipment Co.
Southern Pacific Land Co.
Southern Pacific Pipe Lines, Inc.
Southern Pacific Railroad Co. of Mexico (liquidated effective 8/23/55)
Tijuana & Tecate Railway Co. (stock sold 1970)
Union Terminal Warehouse
Visalia Electric Railroad Co.
Louis Heller, Inc.
Pacific Motor Transport Co.
Pacific Motor Trucking Co.
Southern Pacific Terminal Co. (liquidated effective 8/31/62)
Rio Bravo Oil Co. (subsequently named Bravo Oil Co.)
Southern Pacific Transport Co. (subsequently named Southern Pacific Transport Co. of Texas and Louisiana)
Texas Town Lot Co.
St. Louis Southwestern Railway Co.
St. Louis Southwestern Railway Co. of Texas
Southwestern Transportation Co.
Main Street Warehouse Co.
The Southwestern Town Lot Corp.
Dallas Terminal Railway & Union Depot Co.
Dallas Smith Service Corp. (liquidated effective 4/7/69)
Engineering Enterprises, Inc. (stock sold 1967)
BLC Corp.
Bankers Leasing Corp.
Chattel Leases, Inc.
The Commonwealth Plan, Inc.
The Commonwealth System, Inc.
Financing Leasing Corp.
Lease Capital, Inc.

motion to dismiss for lack of jurisdiction and on its motion, in the alternative, to substitute itself as petitioner in its capacity as the surviving corporation in merger with and as successor in interest to Southern Pacific Co., in its own behalf and as agent for those corporations which were members of the Southern Pacific Co. affiliated group for the taxable years 1962 through 1965.[2]

Prior to its dissolution on November 26, 1969, former Southern Pacific was a corporation organized under the laws of Delaware on March 21, 1947. Transportation was incorporated under Delaware law on February 20, 1969. Sometime before November 26, 1969, S.P. Inc., a newly formed Delaware corporation, acquired the outstanding stock of Transportation, pursuant to the terms of a merger agreement, dated February 20, 1969, among former Southern Pacific, Transportation, and S.P., Inc. In accordance with the merger agreement, former Southern Pacific transferred all of its assets to Transportation and ceased its separate corporate existence. As provided in the merger agreement and pursuant to an amendment to its certificate of incorporation adopted by its board of directors on February 20, 1969, S.P. Inc. changed its name to Southern Pacific Co. (hereinafter new Southern Pacific). The name change took effect on November 26, 1969, the effective date of the merger. Under the merger agreement, the stock of the shareholders of former Southern Pacific was automatically converted into stock of new Southern Pacific. Thus, without any formal surrender of stock certificates, the shareholders of former Southern Pacific, after the merger, became the owners of new Southern Pacific, which had no other shareholders. New Southern Pacific owned all the stock of Transportation which, in turn, owned all the assets of former Southern Pacific.

Lease Funds, Inc.
The Pacific Plan, Inc.
The Worcester Plan, Inc.

All of these corporations or their successors, have joined in the petition, except Engineering Enterprises, Inc., and Tijuana & Tecate Railway Co. (the stock of Engineering Enterprises, Inc., and Tijuana & Tecata Railway Co. was sold after the close of the years at issue). These corporations have joined in the petition to contest the deficiencies set out in the statutory notice of transferee liability in the event that the notice is construed as a notice of deficiency as to each corporation.

[2] The extent of Transportation's liability as a transferee is not at issue. Further, a similar motion was made in a companion case. See *Southern Pacific Co. v. Commissioner*, docket No. 7502-72, 84 T.C. 375 (1985), filed today.

The merger agreement specified that Transportation was the surviving corporation in the merger. Article SECOND of the agreement provided that "all rights of all creditors of, and all liens, mortgages or charges upon the property of [former Southern Pacific] shall be preserved unimpaired." Article THIRD provided as follows:

> On and after the effective date of this agreement [Transportation] hereby expressly assumes liability for obligations of any kind whatsoever, without exception, owed, incurred or assumed by [former Southern Pacific], including, but not limited to, contracts, deeds of trust, indentures, debts, mortgages, liabilities and duties, and all such shall, on and after such effective date, attach to [Transportation] and be enforceable against it and its properties to the same extent as if incurred or contracted by it. On and after such effective date, [Transportation] expressly assumes the due and punctual payment of all outstanding bonds, debentures, equipment trust obligations and conditional sales obligations issued or assumed by [former Southern Pacific], together with interest thereon, according to their tenor, and the due and punctual performance and observance of all the covenants and conditions of any mortgage indenture or other legal instrument under which any of such obligations were issued or assumed. This agreement and merger shall preserve and not impair the lien and security of any such mortgage indenture or other legal instrument and any of the rights and powers of the trustee, bondholders or any other parties thereunder. On or immediately after the effective date of this agreement, [Transportation] shall also execute, and cause to be appropriately recorded, such indentures as the trustee, or any other party to any such mortgage indenture or other legal instrument, may request, and in form satisfactory to such trustee or other party, whereby the obligations of [former Southern Pacific] under any such mortgage indenture or other legal instrument shall be assumed by [Transportation] and [Transportation] shall succeed and be substituted for [former Southern Pacific] thereunder.

For all of the years at issue (calendar year 1962 through 1965), former Southern Pacific filed consolidated returns for itself and as the common parent of an affiliated group of corporations.

In September of 1969, former Southern Pacific and respondent executed Forms 872 extending the period of limitations for assessment of Federal income tax against the former Southern Pacific affiliated group for the years 1962 through 1967 to March 31, 1971. At that time, the limitations period for these years had not expired.

By letter dated December 2, 1969, the San Francisco District Director was advised that former Southern Pacific had ceased to exist and that Transportation was the designated agent of

the affiliated group for all relevant taxable years through the taxable year ended December 31, 1968.

In November of 1970, renewal Forms 872 were executed for the years 1962 through 1967. Each waiver identified the taxpayer as "Southern Pacific Transportation Company, surviving corporation in merger with, and in its own behalf, and as agent for those corporations which were members of the Southern Pacific Company affiliated group during the taxable year below described." The waivers purported to extend the limitations period to September 15, 1971.

In March of 1971, another set of renewal Forms 872 was executed, at the instance of respondent, that purported to extend the limitations period for the years 1962 through 1965 to June 30, 1972, and for the years 1966 and 1967 to September 15, 1972. These waivers described the taxpayer as "Southern Pacific Company (formerly S.P., Inc.)* successor in interest to Southern Pacific Company and common parent of the Southern Pacific affiliated group for the year indicated below." The asterisk referred to a footnote, that stated as follows: "See taxpayer's letter of transmittal as to this language." The transmittal letter objected to the designation of new Southern Pacific as the proper entity to execute waivers.[3]

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[3]The transmittal letter reads as follows:

Mr. Raymond F. Harless
District Director
Internal Revenue Service
P.O. Box 36040
San Francisco, CA 94102

March 29, 1971

Dear Sir:

Attention: *Mr. Benjamin Lemos*

As orally requested we send you herewith six sets of Form 872, "Consent Fixing Period of Limitation Upon Assessment of Income Tax," extending the period of limitations for the taxable years 1962–1965, inclusive, to June 30, 1972, and for the taxable years 1966–1967, inclusive, to September 15, 1972. For reasons discussed by Southern Pacific Law Department personnel with personnel in the San Francisco Office of Regional Counsel, we think inappropriate the manner in which the "taxpayer" is described in these waivers, and have executed them in their present form only because you have asked that we do so notwithstanding our reservations.

We understand that you wish the present waivers to be executed before March 31, 1971, in order that they may become effective before the waivers executed in September 1969 in the name of "Southern Pacific Company and Members of its Affiliated Group" for the years 1962–1966 expire. Accordingly the present waivers upon execution thereof are to be regarded as superseding the waivers executed in November 1970 for the same years in the name of "Southern Pacific Transportation Company, surviving corporation in merger with, and successor in interest to Southern Pacific Company, in its own behalf, and as agent for those corporations which were members of the Southern Pacific Company Affiliated Group."

(S) H. A. Nelson

On June 28, 1972, respondent mailed a statutory notice to new Southern Pacific, determining deficiencies against the affiliated group for the years 1962 through 1965. On the same date, respondent sent Transportation a notice of transferee liability with respect to the consolidated Federal income tax liabilities of the former Southern Pacific affiliated group for the years 1962 through 1965. The notice provides as follows:

> The determination of the income tax liability of Southern Pacific Company and that of its affiliated companies for the taxable years ended December 31, 1962, December 31, 1963, December 31, 1964, and December 31, 1965, discloses deficiencies in the amounts of $14,087,392.33, $10,718,321.15, $11,446,017.27 and $8,827,875.13, respectively, as shown in the attached statement. The amount of the deficiencies, plus interest as provided by law, constitutes your liability as a transferee of assets of said Southern Pacific Company, and will be assessed against you.

Discussion

Petitioner's position in moving for dismissal is that respondent's statutory notice, which determined deficiencies for the years 1962 through 1965 in the consolidated tax liabilities of former Southern Pacific and affiliates, against Transportation as transferee, was invalid and therefore respondent is without authority to assess any tax against it. Transportation maintains that it is primarily liable for any pre-merger tax deficiencies, and can only be held responsible for any deficiencies in that capacity, and that consequently the statutory notice of transferee liability is invalid.

Section 6901(b)[4] of the Code defines the term "transferee" to include a "distributee." The regulations elaborate somewhat on the definition by providing that a "transferee" includes "the successor of a corporation, a party to a reorganization as defined in section 368, and all other classes of distributees." Sec. 301.6901–1(b), Proced. & Admin. Regs.

There is no dispute herein that Transportation is the successor in interest to former Southern Pacific. However, Transportation maintains, on the authority of *Oswego Falls Corp. v. Commissioner*, 26 B.T.A. 60 (1932), affd. 71 F.2d 673 (2d Cir. 1934), and *Saenger v. Commissioner*, 38 B.T.A. 1295 (1938),

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[4] All statutory references are to the Internal Revenue Code of 1954 as in effect during the years at issue.

that it cannot be held liable as a transferee because, under Delaware law and under the merger agreement, it is primarily liable for any obligations of former Southern Pacific.

In *Oswego Falls*, we held that the corporation resulting from the consolidation of three other corporations was primarily liable for any tax deficiencies of the consolidating corporations under New York law, and therefore could not, under State law, be subject to transferee liability. 26 B.T.A. at 69–76. We followed *Oswego Falls* in *Saenger* in holding that the corporation resulting from a consolidation of three corporations under Louisiana law was directly and primarily liable for the predecessor corporations' tax deficiencies as a taxpayer rather than as a transferee. 38 B.T.A. at 1302.[5]

Respondent, on the other hand, argues that *Turnbull, Inc. v. Commissioner*, 42 T.C. 582 (1964), affd. 373 F.2d 91 (5th Cir. 1967), is dispositive of whether or not Transportation is a transferee. In *Turnbull, Inc.*, both this Court and the Fifth Circuit held that the successor in a merger was liable as a transferee for the merged corporation's tax deficiencies where the successor obligated itself under the merger agreement and under a transferee agreement (Form 2045) to pay the liabilities of its predecessor, notwithstanding the fact that the pertinent State merger laws imposed primary liability on the successor. Accord *Texsun Supply Corp. v. Commissioner*, 17 T.C. 433 (1951) (holding that the successor in a merger under Louisiana law as a transferee where the successor assumed the merged corporation's liabilities under the merger agreement and had executed a Form 2045).

In the present case, the relevant Delaware statute, like the New York and Louisiana statutes construed in *Oswego Falls* and *Saenger*, provides that the successor corporation in a merger succeeds to and is liable for the debts and liabilities of the acquired corporation to the same extent as though incurred by the successor corporation. Del. Code Ann. tit. 8, sec. 259 (1953). There is, however, a distinguishing factor in the case before us that was absent in *Oswego Falls* and *Saenger*. Transportation, like the successor corporations in *Turnbull, Inc.* and *Texsun Supply*, contractually obligated itself under

[5] In both *Oswego Falls Corp. v. Commissioner*, 26 B.T.A. 60 (1932), affd. 71 F.2d 673 (2d Cir. 1934), and *Saenger v. Commissioner*, 38 B.T.A. 1295 (1938), the amount of liability was not in dispute, only the nature of the liability.

the merger agreement to pay the liabilities of former Southern Pacific. We hold that this factor renders Transportation liable as a transferee at law,[6] regardless of whether or not Transportation, by virtue of the Delaware statute, is also primarily liable for any deficiencies due from former Southern Pacific. We conclude, therefore, that respondent's notice of transferee liability was proper, and that this Court has jurisdiction over Transportation as a transferee.

We note that Transportation's argument proceeds on the premise that one may not be both primarily liable and liable as a transferee. However, in *United States v. Floersch*, 276 F.2d 714 (10th Cir. 1960), the Tenth Circuit held that a widow, who received her husband's assets upon his death, could be held liable as a transferee for an income tax deficiency of the husband, even though she was also primarily liable for the deficiency by virtue of having filed a joint return with her husband for the year at issue.

Transportation attempts to read the *Floersch* case as supporting its contention that one cannot have both primary and transferee liability "as to the same assets." It would thus appear that Transportation's argument follows from a mistaken conception of the nature of primary liability. The basis for imposition of primary liability is in no way dependent upon the identity of the obligor's assets. Primary liability is a personal liability that may be satisfied from any or all of the obligor's assets.

Transferee liability, on the other hand, is not a personal liability and only subjects the property or fund, which was received by the transferee from the transferor, to the debts of the transferor. Thus, in certain cases, such as that before us, it is possible for a person to be primarily liable for a transferor's debts and also to be liable as a transferee.

Transportation's second contention, that the notice of transferee liability was barred by the statute of limitations, is not a plea to the jurisdiction of this Court but is a defense in bar. *Badger Materials, Inc. v. Commissioner*, 40 T.C. 1061, 1063

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[6] Although Transportation did not execute a Form 2045, as was the case in both *Turnbull, Inc.* and *Texsun Supply*, we find that Transportation's assumption of former Southern Pacific's liabilities in the merger agreement sufficient by itself to support our conclusion that Transportation is a transferee at law. We believe that the execution of the transferee agreements in *Turnbull, Inc.* and *Texsun Supply* simply provided additional evidence of the successor corporation's transferee status.

(1963). It is not therefore a ground upon which dismissal for lack of jurisdiction may be based.

Transportation has filed a motion in the alternative to substitute itself as petitioner herein in its capacity as the successor in interest to former Southern Pacific Co. and as the agent for the former Southern Pacific Co. affiliated group. However, because we have determined that the deficiencies asserted against the affiliated group for taxable years 1962 through 1965 are properly before this Court in docket No. 7502–72, 84 T.C. 375 (1985), we see no reason for granting Transportation's motion herein.

Accordingly,

Transportation's motion to dismiss for lack of jurisdiction and its motion in the alternative to substitute itself as petitioner in its capacity as the surviving corporation in merger with and as successor in interest to Southern Pacific Company, in its own behalf and as agent for those corporations which were members of the Southern Pacific Company affiliated group for the taxable years 1962 through 1965, will be denied.

SOUTHERN PACIFIC COMPANY (FORMERLY S. P. INC.), PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 7502–72. Filed March 12, 1985.

Old SP was the common parent of an affiliated group that filed consolidated income tax returns for the years at issue, calendar years 1962 through 1965. During 1969, but prior to Nov. 26, 1969, new SP and its wholly owned subsidiary, SPTC, were formed. On Nov. 26, 1969, a merger occurred in which (1) SPTC received all the assets of old SP, (2) the shareholders of old SP became the shareholders of new SP, (3) old SP was dissolved, and (4) new SP assumed the name of old SP. Respondent was notified on Dec. 2, 1969, of the dissolution of old SP and that SPTC had been designated as successor agent for the affiliated group for years ended before the merger.

On June 28, 1972, respondent mailed a statutory notice, determining deficiencies against the affiliated group for the

years 1962 through 1965 to new SP as the successor agent for the affiliated group. Petitioner filed a motion to dismiss on the grounds that SPTC, rather than new SP, was the successor agent for the group and was the proper entity to receive the statutory notice of deficiency. *Held*: That under the reverse acquisition rule of section 1.1502–75(d)(3), Income Tax Regs., new SP became the common parent for the group and was the proper entity to receive the statutory notice of deficiency for the group. The notice was therefore valid, and petitioner's motion to dismiss is denied.

Arnold I. Weber, Alan S. Beinhorn, and *William E. Saul*, for the petitioner.

Peter D. Bakutes, James Booher, Vernon R. Balmes, Bernard Plamer, Lawrence G. Becker, and *Randall G. Dick*, for the respondent.

OPINION

Background

JACOBS, *Judge*:* This case is before the Court on petitioner's motion to dismiss for lack of jurisdiction. "Petitioners," as the word is used in this opinion, refers to Southern Pacific Co. (formerly S.P. Inc.) and a group of affiliated corporations.[1]

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*By order of the Chief Judge, this case was reassigned from Judge William M. Drennen to Judge Julian I. Jacobs for disposition.

[1]The members of the affiliated group for the years in issue, 1962 through 1965, that have joined in this petition include:

Holton Inter-Urban Railway Co.
Los Angeles Union Terminal Co., Inc.
Northwestern Pacific Railroad Co.
Pacific Petroleum Pipe Lines, Inc.
Petaluma & Santa Rosa Railroad Co.
San Diego & Arizona Eastern Railway Co.
Southern Pacific Equipment Co.
Southern Pacific Land Co.
Union Terminal Warehouse
Visalia Electric Railroad Co.
Dallas Terminal Railway & Union Depot Co.
Main Street Warehouse Co.
The Southwestern Town Lot Corp.
St. Louis Southwestern Railway Co.
St. Louis Southwestern Railway Co. of Texas
Louis Heller, Inc.
Pacific Motor Transport Co.
Pacific Motor Trucking Co.
Southern Pacific Transport Co. of Texas and Louisiana (formerly Southern Pacific Transport Co.)
Southwestern Transportation Co.

Prior to its dissolution on November 26, 1969, Southern Pacific Co. (hereinafter former Southern Pacific), a corporation organized under the laws of Delaware on March 21, 1947, was the parent company of an affiliated group. Southern Pacific Transportation Co. (hereinafter Transportation) was incorporated under Delaware law on February 20, 1969. Sometime before November 26, 1969, S.P. Inc., a newly formed Delaware corporation, acquired the outstanding stock of Transportation, pursuant to the terms of a merger agreement dated February 20, 1969, among former Southern Pacific, Transportation, and S.P. Inc. In accordance with the merger agreement, former Southern Pacific transferred all of its assets to Transportation and ceased its separate corporate existence. As provided in the merger agreement and pursuant to an amendment to its certificate of incorporation adopted by its board of directors on February 20, 1969, S.P. Inc. changed its name to Southern Pacific Co. (hereinafter new Southern Pacific). The name change took effect on November 26, 1969, the effective date of the merger. Under the merger agreement, the stock of the shareholders of former Southern Pacific was automatically converted into stock of new Southern Pacific. Thus, without any formal surrender of stock certificates, the

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Southern Pacific Pipe Lines, Inc.
Bankers Leasing Corp.
BLC Corp.
Chattel Leases, Inc.
The Commonwealth Plan, Inc.
The Commonwealth System, Inc.
Financial Leasing Corp.
Lease Capital, Inc.
Lease Funds, Inc.
The Pacific Plan, Inc.
The Worcester Plan, Inc.
Southern Pacific Terminal Co. (liquidated 8/31/62)
Pacific Electric Railway Co. (merged into former Southern Pacific Co. 8/13/65)
Southern Pacific Railroad Co. of Mexico (liquidated 8/23/55)
Nacozari Rail Road Co. (liquidated 5/5/66)
Inter-California Railway Co. (liquidated 7/25/66)
Dallas Smith Service Corp. (liquidated 4/7/69)
Bravo Oil Co. (formerly Rio Bravo Oil Co.)
Texas Town Lot Co.

In addition to these corporations, the consolidated returns for the years 1962 through 1965 included Tijuana & Tecate Railway Co. (the entire outstanding stock of which was sold in 1970) and Engineering Enterprises, Inc. (the entire stock of which was sold in 1967).

Southern Pacific Transportation Co. has joined in the petition as the successor in interest to former Southern Pacific Co. Southern Pacific Co. (formerly S.P. Inc.) has brought the petition as the entity to which the statutory notice was addressed.

shareholders of former Southern Pacific, after the merger, became the owners of new Southern Pacific, which had no other shareholders. New Southern Pacific owned all the stock of Transportation which, in turn, owned all the assets of former Southern Pacific.

For all of the years at issue herein (calendar years 1962 through 1965), former Southern Pacific filed consolidated returns for itself and as the common parent of a group of affiliated companies.

In September of 1969, former Southern Pacific and respondent executed Forms 872 extending the period of limitations for assessment of Federal income tax against the former Southern Pacific consolidated group for the years 1962 through 1967 to March 31, 1971. The limitations period for these years was at the time still open.

By letter, dated December 2, 1969, the San Francisco District Director was advised that former Southern Pacific had ceased to exist and that Transportation was designated as the agent of the consolidated group for all relevant taxable years through the taxable year ended December 31, 1968.

In November 1970, renewal Forms 872 were executed for the years 1962 through 1967. Each waiver identified the taxpayer as "Southern Pacific Transportation Company, surviving corporation in merger with, and in its own behalf, and as agent for those corporations which were members of the Southern Pacific Company affiliated group during the taxable year below described." The waivers purported to extend the limitations period to September 15, 1971.

In March 1971, another set of Forms 872 was executed, at the instance of respondent, that purported to extend the statute of limitations for the years 1962 through 1965 to June 30, 1972, and for the years 1966 and 1967 to September 15, 1972. These waivers described the taxpayer as "Southern Pacific Company (formerly S.P., Inc.)* successor in interest to Southern Pacific Company and common parent of the Southern Pacific affiliated group for the year indicated below." The asterisk, which was inserted by petitioners, referred to a footnote, also inserted by petitioners, that stated as follows: "See taxpayer's letter of transmittal as to this langu[illegible]e." The transmittal letter objected to the designation of new S[illegible]uthern

Pacific as the proper entity to execute the waivers.[2]

The notice of deficiency for the years 1962 through 1965 was sent to "Southern Pacific Company (formerly S.P., Inc.), successor in interest to Southern Pacific Company, and common parent of the Southern Pacific Affiliated Group" on June 28, 1972,[3] and forms the basis for the proceeding herein.

Discussion

Petitioners argue that the petition herein must be dismissed on the ground that respondent failed to direct the notice determining deficiencies in their consolidated income tax liabilities for the years 1962 through 1965 to the proper party. Specifically, petitioners maintain that the determination of deficiencies for the years 1962 through 1965 against new Southern Pacific, as successor in interest to former Southern Pacific and as common parent of the affiliated group, was erroneous because new Southern Pacific was not, under the consolidated return regulations, the agent authorized to act for the affiliated group with respect to matters concerning the pre-merger taxable years of the group. Consequently, petition-

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[2]The transmittal letter reads as follows:

Mr. Raymond F. Harless
District Director
Internal Revenue Service
P.O. Box 36040
San Francisco, CA 94102

March 29, 1971

Dear Sir:

Attention: *Mr. Benjamin Lemos*

As orally requested we send you herewith six sets of Form 872, "Consent Fixing Period of Limitation Upon Assessment of Income Tax," extending the period of limitation for the taxable years 1962–1965, inclusive, to June 30, 1972, and for the taxable years 1966–1967, inclusive, to September 15, 1972. For reasons discussed by Southern Pacific Law Department personnel with personnel in the San Francisco Office of Regional Counsel, we think inappropriate the manner in which the "taxpayer" is described in these waivers, and have executed them in their present form only because you have asked that we do so notwithstanding our reservations.

We understand that you wish the present waivers to be executed before March 31, 1971, in order that they may become effective before the waivers executed in September 1969 in the name of "Southern Pacific Company and Members of its Affiliated Group" for the years 1962–1966 expire. Accordingly the present waivers upon execution thereof are to be regarded as superseding the waivers executed in November 1970 for the same years in the name of "Southern Pacific Transportation Company, surviving corporation in merger with, and successor in interest to Southern Pacific Company, in its own behalf, and as agent for those corporations which were members of the Southern Pacific Company Affiliated Group."

(S) H. A. Nelson

[3]In addition to determining deficiencies in the consolidated income tax liabilities of the affiliated group, the statutory notice disallowed refund claims, filed on Sept. 13, 1971, for calendar years 1962 through 1965.

ers claim that new Southern Pacific is not the proper party against which any deficiency attributable to the years 1962 through 1965 may be determined, and that this Court has no jurisdiction over the members of the affiliated group for the years 1962 through 1965 because respondent failed to direct the statutory notice to the proper agent for the group.

The jurisdiction of this Court can be invoked only by the timely filing of a petition by a taxpayer to whom a notice of deficiency is addressed. Sec. 6213(a).[4] As we pointed out in *Intervest Enterprises, Inc. v. Commissioner*, 59 T.C. 91, 94 (1972), there are at least three prerequisites to this Court's exercise of jurisdiction: (1) A notice, (2) the determination of a deficiency in the notice, and (3) the transmittal of the notice to the taxpayer. In the case before us, the controversy is focused upon whether the third of these requirements has been met, and requires, for its resolution, consideration of the consolidated return regulations.

At the outset, we note that the consolidated return regulations, which have been promulgated under the express authority granted in section 1502 and therefore are legislative in character, underwent a comprehensive revision in 1965 and 1966. B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders 15–51 n. 118 (4th ed. 1979). The revised regulations, which were adopted in final form in 1966, T.D. 6894, 1966–2 C.B. 362, were made effective only with respect to taxable years beginning after December 31, 1965. Sec. 1.1502–0(a), Income Tax Regs. The provisions of the former version of the regulations, sometimes referred to as the "A" regulations, are applicable to taxable years beginning before January 1, 1966. Sec. 1.1502–0(b), Income Tax Regs. Thus, for the years with which we are concerned in this proceeding, calendar years 1962 through 1965, it is the pre-1966 version of the regulations that governs.

A central feature of both versions of the consolidated return regulations is the role of the common parent as the exclusive agent for the affiliated group with respect to all procedural matters. In delineating the scope of the common parent's agency, the regulations specifically provide that the common parent shall act as the agent for all the affiliates for such

[4] All statutory references are to the Internal Revenue Code of 1954 as in effect during the years at issue.

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purposes as receiving deficiency notices, filing refund claims, and executing waivers of the statute of limitations.[5] Secs. 1.1502–77, 1.1502–16A, Income Tax Regs.

Section 1.1502–16A of the pre-1966 regulations states the general rule:

"the common parent shall be for all purposes * * * *in respect of the tax for the taxable year for which a consolidated return is made or is required*, the sole agent, duly authorized to act in its own name in all matters relating to such tax, for each corporation which during any part of such year was a member of the affiliated group."[6] [Emphasis added.]

By its terms, the regulation contemplates that the common parent's authority to act as agent for the affiliated group arises on a year-by-year basis. Thus, for any given year in which a consolidated return is filed, the entity that is the common parent for that particular year is thereafter the sole agent with respect to any procedural matters that may arise in connection with the group's tax liability for that year.

Obviously, if the existence of the common parent were to terminate after the filing of a consolidated return for a particular year, the agency relationship would terminate, and the group would, in the absence of any provision in the regulations, be left without an agent to act on its behalf in any subsequent dispute over its liability for that year. The regulations, however, address this possibility. Section 1.1502–16A(c), Income Tax Regs., prescribes the following procedures:

(c) *Effect of dissolution of common parent corporation.* If the common parent corporation contemplates dissolution, or is about to be dissolved, or if for any other reason its existence is about to terminate, it shall forthwith notify the Commissioner of such fact and designate, subject to the approval of the Commissioner, another member of the affiliated group to act as agent in its place to the same extent and subject to the same conditions and limitations as are applicable to the common parent. If the notice thus required is not given by the common parent, the remaining members of the

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[5] Petitioners' brief cursorily refers to *Community Water Service Co. v. Commissioner*, 32 B.T.A. 164 (1935), but the issue involved therein is not now before us.

[6] The general rule is reiterated in the post-1965 regulations as follows:

"The common parent, for all purposes (other than the making of the consent required by paragraph (a)(1) of sec. 1.1502–75, the making of an election under section 936(e), the making of an election to be treated as a DISC under sec. 1.992–2, and a change of the annual accounting period pursuant to paragraph (b)(3)(ii) of sec. 1.991–1) shall be the sole agent for each subsidiary in the group, duly authorized to act in its own name *in all matters relating to the tax liability for the consolidated return year.* [Sec. 1.1502–77(a), Income Tax Regs. Emphasis added.]"

group may, subject to the approval of the Commissioner, designate another member of the group to act as such agent, and notice of such designation shall be given to the Commissioner. Until a notice in writing designating a new agent has been received by the Commissioner, any notice of deficiency or other communication mailed to the common parent shall be considered as having been properly mailed to the agent of the group; or, if the Commissioner has reason to believe that the existence of the common parent has terminated, he may, if he deems it advisable, deal directly with any member of the group in respect of its liability.

Petitioners maintain that the December 2, 1969, letter to the District Director satisfied the requirement in the regulation that notice of designation be given to the Commissioner and that respondent's failure to notify petitioners of any objection to the designation of Transportation as the successor agent at that time amounted to approval of Transportation as the designated agent. Thus, petitioners conclude that Transportation is the properly designated agent for the affiliated group and that respondent's failure to address the notice of deficiency to Transportation deprives this Court of jurisdiction.

In response to petitioners' argument, respondent maintains that the reverse acquisition rule of section 1.1502–75(d)(3), Income Tax Regs., which was introduced as part of the 1966 revision and which applies to mergers occurring after October 1, 1965, requires a different result. Respondent contends that, because the 1969 acquisition of all of the former Southern Pacific's assets by the group consisting of new Southern Pacific and Transportation constituted a reverse acquisition under the regulations (sec. 1.1502–75(d)(3)(i)(b), Income Tax Regs.), of the post-1965 regulations not only provides that the affiliation of the former Southern Pacific group continued uninterrupted after the merger, but requires that new Southern Pacific must be treated as the common parent agent for the group for all years, both before and after the merger. Respondent also argues that, in any event, the designation of Transportation as the successor agent was invalid under section 1.1502–16A(c), Income Tax Regs., and that, therefore, respondent could properly ignore the designation.

We turn first to respondent's contention that the reverse acquisition rule applies in determining which entity is to be treated as the agent for the surviving affiliated group for taxable years before the acquisition.

Section 1.1502–75(d)(1), Income Tax Regs., provides the general rule that an affiliated group is deemed to remain in existence as long as the common parent remains the common parent and at least one subsidiary remains affiliated with it. The regulations recognize three exceptions to the general rule, each of which provides that the affiliated group is still deemed to remain in existence even though the common parent does not remain as the common parent. One of these exceptions is the reverse acquisition rule of section 1.1502–75(d)(3), Income Tax Regs.[7]

The reverse acquisition rule, by its terms, applies to mergers occurring after October 1, 1965. The rule provides that an affiliated group will not terminate where the stock or assets of the common parent are acquired by another corporation in exchange for the stock of that other corporation, provided that the shareholders of the acquired common parent, after the acquisition, own more than 50 percent of the value of the acquiring corporation's stock. Sec. 1.1502–75(d)(3)(i), Income Tax Regs. If the acquiring corporation, before the acquisition, is a common parent of an affiliated group, that group is deemed to terminate even though the acquiring corporation/common parent continues to exist for all purposes except those of the consolidated return provisions. The rule is clearly designed to eliminate the discretion that the shareholders of the two merging groups might otherwise have to determine which group survives, given the shareholders' ability to select which parent survives the merger.

Section 1.1502–75(d)(3)(i), Income Tax Regs., further provides that, after the acquisition, the acquiring corporation is to be treated as the common parent of the group that is deemed to survive the reverse acquisition. Respondent interprets this provision as requiring that the acquiring corporation must be treated as the common parent agent with respect to matters arising in connection with returns filed by the former common parent for taxable years that predate the acquisition, as well as with respect to the filing of consolidated returns in post-acquisition taxable years.

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[7] The other two exceptions set forth in the regulations are where the common parent undergoes a reorganization described in sec. 368(a)(1)(F) and where there is a downstream transfer of the common parent's assets. Sec. 1.1502–75(d)(2)(i) and (ii), Income Tax Regs.

Petitioners, in disputing respondent's interpretation, maintain that the reverse acquisition rule is inapplicable to the question of which entity succeeds as agent for the group for taxable years 1962 through 1965, because (1) the rule only applies with respect to questions regarding the continuity of affiliated status and to questions regarding limitations on carryovers, and (2) the rule, having been adopted as part of the post-1965 regulations, is inapplicable to years governed by the pre-1966 regulations.

We do not agree with petitioners' contention that the reverse acquisition rule does not apply in determining which entity succeeds as agent for the affiliated group for the years ended prior to a reverse acquisition. We believe that the language of section 1.1502–75(d)(3)(i), Income Tax Regs.—"with the [acquiring] corporation becoming the common parent of the group"—clearly contemplates a metamorphosis of the acquiring common parent into the acquired common parent for the purposes of the consolidated return provisions. Petitioners have not advanced any policy reason for limiting the extent to which the new common parent steps into the shoes of the old common parent under the reverse acquisition rule, and we fail to see any justification for doing so. Indeed, we find that respondent's interpretation has much to recommend it in terms of administrative simplicity. Accordingly, we hold that the reverse acquisition rule applies in determining which entity succeeds the common parent as agent for the affiliated group with respect to years both *before* and *after* the reverse acquisition.

We next turn to petitioners' objection that the reverse acquisition rule does not apply to years governed by the pre-1966 regulations. It is true, as we have previously discussed, that section 1.1502–0(a), Income Tax Regs., provides that the post-1965 regulations apply to taxable years beginning after December 31, 1965. But the reverse acquisition rule, by its terms, applies to mergers occurring after October 1, 1965. We read the language of section 1.1502–75(d)(3), Income Tax Regs., as posing an exception to the general rule of non-retroactivity embodied in section 1.1502–0(a), Income Tax Regs.[8]

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[8] Sec. 1.1502–75(d)(3), Income Tax Regs., is not the only provision of the post-1965 regulations that has an effective date that differs from the general effective date provided in sec. 1.1502–0(a), Income Tax Regs.

We believe that this interpretation is the only way to reconcile the apparent conflict between the specific language of section 1.1502–75(d)(3), Income Tax Regs., and the general effective date provided in section 1.1502–0(a), Income Tax Regs. Any other interpretation would render meaningless the specific provision in section 1.1502–75(d)(3), Income Tax Regs. If, for example, a reverse acquisition occurred on October 30, 1965, and the affiliated group reports on a calendar year basis, section 1.1502–75(d)(3), Income Tax Regs., by its terms, applies to the acquisition and, under section 1.1502–0(b), Income Tax Regs., the group's return for 1965 is governed by the pre-1966 regulations. In this example, the only logical approach would be to give effect to the specific effective date in section 1.1502–75(d)(3), Income Tax Regs., despite the apparently conflicting general non-retroactivity provision in section 1.1502–0(a), Income Tax Regs. Thus, the reverse acquisition rule becomes operative whenever a reverse acquisition occurs after October 1, 1965, without regard to section 1.1502–0, Income Tax Regs. There is no reason to believe that the drafters of the post-1965 regulations intended to limit the operative effects of the rule, once triggered, to years beginning after December 31, 1965, and petitioners have advanced no reason for our doing so.

There is no dispute that the November 26, 1969, merger constituted a reverse acquisition that occurred after October 1, 1965, within the meaning of section 1.1502–75(d)(3)(i), Income Tax Regs. As we concluded, *supra*, new Southern Pacific, as a result of the merger, became the successor common parent agent for the group for taxable years both before and after the merger. In view of our conclusion that, in the context of this case, the scope of the operation of the reverse acquisition rule is not limited to post-1965 years, we hold that, under the

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The consolidated return change in ownership (CRCO) provisions of the post-1965 regulations apply to ownership changes made after Oct. 1, 1965. Sec. 1.1502–1(g)(1), Income Tax Regs. Similarly, the version of the built-in deduction provisions that was adopted as part of the revised regulations in 1966 was also made effective as to subsidiaries acquired on or after Oct. 1, 1965. Sec. 1.1502–15(a)(3), Income Tax Regs., T.D. 6894, 1966–2 C.B. 362, 392–393.

In the case of the built-in deduction provisions, it is interesting to note that the pre-1966 version of the rules continued to apply in post-1965 years to corporations acquired before Oct. 1, 1965, under the post-1965 built-in deduction provisions adopted in 1966, 1966–2 C.B. *supra*, at 392–393. The transitional rule adopted in the 1972 amendments to the built-in deduction provisions, T.D. 7246, 1973–1 C.B. 381, 386, continued the applicability of the pre-1966 provisions to certain assets acquisitions occurring on or before Apr. 17, 1968. Sec. 1.1502–15(a)(3), Income Tax Regs.

reverse acquisition rule, new Southern Pacific became the successor common parent agent for those pre-merger taxable years governed by the pre-1966 regulations as well as those governed by the post-1965 regulations. Respondent properly addressed the notice of deficiency for the affiliated group to new Southern Pacific as the successor common parent agent, and we have therefore jurisdiction over the affiliated group for the years 1962 through 1965.

In support of our holding that the reverse acquisition rule applies in determining which entity may act as agent for the group with respect to taxable years 1962 through 1965, we note that section 1.1502–75(d)(3), Income Tax Regs., adopts a substance-over-form approach,[9] an approach that we find applicable in a factual situation such as the one before us. The approach adopted in section 1.1502–75(d)(3), Income Tax Regs., is that where there is sufficient shareholder continuity from the acquired corporation to constitute control of the acquiring corporation, the substance of the change in formal corporate arrangements should control for purposes of the consolidated return provisions.

There was, both before and after the November 26, 1969, merger, complete identity of proprietary interest. As a result of the November 26, 1969, transaction, a holding company (new Southern Pacific) was established to hold stock of a company (Transportation) holding the operating assets of old Southern Pacific. Although, after the acquisition, there was a difference between the assets held by new Southern Pacific (stock in Transportation) and the assets held by old Southern Pacific (operating assets), this difference was simply the result of what, in practical effect, amounted to an ancillary "drop-down" of former Southern Pacific's operating assets to a wholly owned subsidiary (Transportation). When viewed in this manner, the merger and the acquisition can be isolated as separate steps. An examination of the merger by itself discloses that the transaction was a mere change in form—all the shareholders of old Southern Pacific became the only shareholders of new Southern Pacific, which held, in practical effect, the same assets as its predecessor. The simultaneous drop-down did not alter this fact. Given that the merger

[9] See B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, par. 15.24, at 15-77 (4th ed. 1979).

merely effected a formal change in corporate structure, we believe that in substance new Southern Pacific was a continuation of former Southern Pacific as the controlling (parent) corporation of the affiliated group.

It follows from our view of the scope of the operation of the reverse acquisition rule that section 1.1502–75(d)(3), Income Tax Regs., effectively overrides section 1.1502–16A(c), Income Tax Regs., with respect to a determination of the successor agent for pre-acquisition years following a reverse acquisition that occurred on or after October 1, 1965. Consequently, we need not discuss the parties' arguments under section 1.1502–16A(c), Income Tax Regs.

Petitioners also alleged as a ground for dismissal for lack of jurisdiction that the notice of deficiency was in any event barred by the statute of limitations. Petitioners have since abandoned this argument, recognizing that a claim as to the untimeliness of a deficiency notice is one that requires a determination on the merits and is not a ground upon which dismissal may be granted. *Badger Materials, Inc. v. Commissioner*, 40 T.C. 1061 (1963). In any event, petitioners base their claim as to the untimeliness of the statutory notice on their claim that new Southern Pacific is not the proper agent for pre-merger years and therefore had no authority to execute any Forms 872. Even if the untimeliness of a statutory notice was a proper ground for dismissal, for lack of jurisdiction, our holding that new Southern Pacific had the authority to act for the group would result in the denial of petitioners' motion on this ground.

Accordingly,

Petitioners' motion to dismiss for lack of jurisdiction will be denied.

SOUTHERN PACIFIC TRANSPORTATION COMPANY, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 8647–72. Filed March 12, 1985.

Old SP was the common parent of an affiliated group which filed consolidated returns for the years at issue, calendar years

1966 through 1968. During 1969, but prior to Nov. 26, 1969, new SP and its wholly owned subsidiary, SPTC, were formed. On Nov. 26, 1969, a merger occurred in which (1) SPTC acquired all the assets of old SP, (2) the shareholders of old SP became the sole shareholders of new SP, (3) old SP was dissolved, and (4) new SP assumed the name of old SP. Contractually under the merger agreement, as well as legally under State law, SPTC, as successor in interest to old SP, became primarily liable for the obligations of old SP.

On Sept. 1, 1972, respondent mailed a statutory notice to new SP, determining deficiencies against the affiliated group for the years 1966–68. On the same date, respondent mailed a statutory notice of transferee liability to SPTC. The notice determined liability for deficiencies in the consolidated income tax liabilities of the old SP affiliated group for the years 1966–68 against SPTC, as transferee of old SP.

SPTC filed a motion to dismiss on the grounds that it is primarily liable under State law for all pre-merger deficiencies determined against the affiliated group for the years 1966 through 1968 and that the notice of transferee liability was therefore invalid.

Held: That SPTC is liable as a transferee at law for the liabilities of old SP because SPTC contractually assumed the obligations of old SP under the merger agreement, regardless of the fact that SPTC is primarily liable under State law. Respondent's notice of transferee liability was proper and therefore SPTC's motion to dismiss is denied.

Arnold I. Weber, Alan S. Beinhorn, and *William E. Saul*, for the petitioner.

Peter D. Bakutes, James Booher, Vernon R. Balmes, Bernard Plamer, Lawrence G. Becker, and *Randall G. Dick*, for the respondent.

OPINION

Background

JACOBS, *Judge*:* This case is before the Court on Southern Pacific Transportation Company's ("Transportation") motion to dismiss for lack of jurisdiction.[1] Transportation instituted

*By order of the Chief Judge, this case was reassigned from Judge William M. Drennen to Judge Julian I. Jacobs for disposition.

[1] The extent of Transportation's liability as a transferee is not at issue. Further, a similar motion was made in a companion case. See *Southern Pacific Co. v. Commissioner*, docket No. 8648-72, 84 T.C. 395, filed today.

this proceeding in its capacity as transferee of the assets of Southern Pacific Co. (former Southern Pacific), the common parent of an affiliate group of corporations.[2]

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[2]The members of the affiliated group included in the consolidated returns filed for 1966 through 1968, the years in issue, are as follows:

Southern Pacific Co. (former Southern Pacific)
Black Mesa Pipe Lines, Inc.
Holton Inter-Urban Railway Co.
Inter-California Railway Co. (liquidated 7/25/66)
Los Angeles Union Terminal, Inc.
Monarch Brewing Co.
Nacozari Railroad Co. (liquidated 5/5/66)
Nevazona Corp.
Northwestern Pacific Railroad Co.
Pacific Petroleum Pipe Lines, Inc.
Petaluma & Santa Rosa Railroad Co.
San Diego & Arizona Eastern Railway Co.
Southern Pacific Air Freight, Inc.
Southern Pacific Equipment Co.
Southern Pacific Land Co.
Southern Pacific Pipe Lines, Inc.
Tijuana & Tecate Railway Co. (entire stock sold 1970)
Union Terminal Warehouse (subsequently named Southern Pacific Warehouse Co.)
Visalia Electric Railroad Co.
Louis Heller, Inc.
Pacific Motor Transport Co.
Pacific Motor Trucking Co.
Southern Pacific Marine Transport, Inc.
Southern Pacific Transport Co. (subsequently named Southern Pacific Transport Co. of Texas and Louisiana)
Southwestern Transportation Co.
BLC Corp.
Bankers Leasing Corp.
Chattel Leases, Inc.
Commonwealth Control, Inc.
The Commonwealth Plan, Inc.
The Commonwealth System, Inc.
Financial Leasing Corp.
Lease Capital Inc.
Lease Funds, Inc.
The Midwest Commonwealth Plan, Inc.
The Pacific Plan, Inc.
The Worcester Plan, Inc.
Evergreen Leasing Corp.
Evergreen Freight Car Corp.
Bravo Oil Co.
Texas Town Lot Co.
St. Louis Southwestern Railway Co.
St. Louis Southwestern Railway Co. of Texas
The Southwestern Town Lot Corp.
Dallas Terminal Railway & Union Depot Co.
Main Street Warehouse Co.
Dallas Smith Service Corp. (liquidated 4/7/69)
Engineering Enterprises, Inc. (entire stock sold 1967)

Except for Nacozari Railroad Co., Tijuana & Tecate Railway Co., and Engineering Enterprises, Inc., all the above corporations have verified the petition. These corporations have joined in the

Prior to its dissolution on November 26, 1969, former Southern Pacific was a corporation organized under the laws of Delaware on March 21, 1947. Transportation was incorporated under Delaware law on February 20, 1969. Sometime before November 26, 1969, S.P. Inc., a newly formed Delaware corporation, acquired the outstanding stock of Transportation, pursuant to the terms of a merger agreement, dated February 20, 1969, among former Southern Pacific, Transportation, and S.P. Inc. In accordance with the merger agreement, former Southern Pacific transferred all of its assets to Transportation and ceased its separate corporate existence. As provided in the merger agreement and pursuant to an amendment to its certificate of incorporation adopted by its board of directors on February 20, 1969, S.P. Inc. changed its name to Southern Pacific Co. (hereinafter new Southern Pacific). The name change took effect on November 26, 1969, the effective date of the merger. Under the merger agreement, the stock of the shareholders of former Southern Pacific was automatically converted into stock of new Southern Pacific. Thus, without any formal surrender of stock certificates, the shareholders of former Southern Pacific, after the merger, became the owners of new Southern Pacific, which had no other shareholders. New Southern Pacific owned all the stock of Transportation which, in turn, owned all the assets of former Southern Pacific.

The merger agreement specified that Transportation was the surviving corporation in the merger. Article SECOND of the agreement provided that "all rights of all creditors of, and all liens, mortgages or charges upon the property of [former Southern Pacific] shall be preserved unimpaired." Article THIRD provided as follows:

> On and after the effective date of this agreement [Transportation] hereby expressly assumes liability for obligations of any kind whatsoever, without exception, owed, incurred or assumed by [former Southern Pacific], including, but not limited to, contracts, deeds of trust, indentures, debts, mortgages, liabilities and duties, and all such shall, on and after such effective date, attach to [Transportation] and be enforceable against it and its properties to the same extent as if incurred or contracted by it. On and after such effective date [Transportation] expressly assumes the due and punctual

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petition to contest the deficiencies set out in the statutory notice of transferee liability in the event that the notice is construed as a notice of deficiency as to each corporation.

payment of all outstanding bonds, debentures, equipment trust obligations and conditional sales obligations issued or assumed by [former Southern Pacific], together with interest thereon, according to their tenor, and the due and punctual performance and observance of all the covenants and conditions of any mortgage indenture or other legal instrument under which any of such obligations were issued or assumed. This agreement and merger shall preserve and not impair the lien and security of any such mortgage indenture or other legal instrument and any of the rights and powers of the trustee, bondholders or any other parties thereunder. On or immediately after the effective date of this agreement, [Transportation] shall also execute, and cause to be appropriately recorded, such indentures as the trustee, or any other party to any such mortgage indenture or other legal instrument, may request, and in form satisfactory to such trustee or other party, whereby the obligations of [former Southern Pacific] under any such mortgage indenture or other legal instrument shall be assumed by [Transportation] and [Transportation] shall succeed and be substituted for [former Southern Pacific] thereunder.

For all of the years at issue (calendar years 1966 through 1968), former Southern Pacific filed consolidated returns for itself and as the common parent of an affiliated group of corporations.

In September of 1969, former Southern Pacific and respondent executed Forms 872 extending the period of limitations for assessment of Federal income tax against the former Southern Pacific consolidated group for the years 1962 through 1967 to March 31, 1971. At that time, the limitations period for each of these years had not expired.

By letter dated December 2, 1969, the San Francisco District Director was advised that former Southern Pacific had ceased to exist and that Transportation was the designated agent of the affiliated group for all relevant taxable years through the taxable year ended December 31, 1968.

In November of 1970, renewal Forms 872 were executed for the years 1962 through 1967. Each waiver identified the taxpayer as "Southern Pacific Transportation Company, surviving corporation in merger with, and in its own behalf, and as agent for those corporations which were members of the Southern Pacific Company affiliated group during the taxable year below described." The waivers purported to extend the limitations period to September 15, 1971.

In March of 1971, another set of renewal Forms 872 was executed, at the instance of respondent, that purported to extend the limitations period for the years 1962 through 1965,

to June 30, 1972, and for the years 1966 and 1967, to September 15, 1972. These waivers described the taxpayer as "Southern Pacific Company (formerly S.P., Inc.)* successor in interest to Southern Pacific Company and common parent of the Southern Pacific affiliated group for the year indicated below." The asterisk referred to a footnote, that stated as follows: "See taxpayer's letter of transmittal as to this language." The transmittal letter objected to the designation of new Southern Pacific as the proper entity to execute waivers.[3]

On September 1, 1972, respondent mailed a statutory notice to new Southern Pacific, determining deficiencies against the affiliated group for the years 1966 through 1968. On the same date, respondent sent Transportation a notice of transferee liability with respect to the consolidated Federal income tax liabilities of the former Southern Pacific affiliated group for the years 1966 through 1968. The notice provides as follows:

> The determination of the income tax liability of Southern Pacific Company and that of its affiliated companies for the taxable years ended December 31, 1966, December 31, 1967, and December 31, 1968, discloses deficiencies in the amounts of $8,972,805.95, $10,590,946.89, and $21,499,082.53, respectively, as shown in the accompanying statement. The amount of the deficiencies, plus interest as provided by law, constitutes your liability as a transferee of assets of said Southern Pacific Company, and will be assessed against you.

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[3]The transmittal letter reads as follows:

> Mr. Raymond F. Harless — March 29, 1971
> District Director
> Internal Revenue Service
> P.O. Box 36040
> San Francisco, CA 94102
> Dear Sir: — Attention: *Mr. Benjamin Lemos*
>
> As orally requested we send you herewith six sets of Form 872, "Consent Fixing Period of Limitation Upon Assessment of Income Tax," extending the period of limitation for the taxable years 1962–1965, inclusive, to June 30, 1972, and for the taxable years 1966–1967, inclusive, to September 15, 1972. For reasons discussed by Southern Pacific Law Department personnel with personnel in the San Francisco Office of Regional Counsel, we think inappropriate the manner in which the "taxpayer" is described in these waivers, and have executed them in their present form only because you have asked that we do so notwithstanding our reservations.
>
> We understand that you wish the present waivers to be executed before March 31, 1971, in order that they may become effective before the waivers executed in September 1969 in the name of "Southern Pacific Company and Members of its Affiliated Group" for the years 1962–1966 expire. Accordingly the present waivers upon execution thereof are to be regarded as superseding the waivers executed in November 1970 for the same years in the name of "Southern Pacific Transportation Company, surviving corporation in merger with, and successor in interest to Southern Pacific Company, in its own behalf, and as agent for those corporations which were members of the Southern Pacific Company Affiliated Group."
>
> (S) H. A. Nelson

Discussion

Transportation's position in moving for dismissal is that respondent's statutory notice, which determined deficiencies in the consolidated tax liabilities of former Southern Pacific and affiliates for the years 1966 through 1968 against Transportation as transferee, was invalid and therefore respondent is without authority to assess any tax against it. Transportation maintains that it is primarily liable for any pre-merger tax deficiencies, and can only be held responsible for any deficiencies in that capacity, and that consequently the statutory notice of transferee liability is invalid.

Section 6901(b)[4] defines the term "transferee" to include a "distributee." The regulations elaborate somewhat on the definition by providing that a "transferee" includes "the successor of a corporation, a party to a reorganization as defined in section 368, and all other classes of distributees." Sec. 301.6901–1(b), Proced. & Admin. Regs.

There is no dispute herein that Transportation is the successor to former Southern Pacific. However, Transportation maintains that, on the authority of *Oswego Falls Corp. v. Commissioner*, 26 B.T.A. 60 (1932), affd. 71 F.2d 673 (2d Cir. 1934), and *Saenger v. Commissioner*, 38 B.T.A. 1295 (1938), it cannot be held liable as a transferee because, under Delaware law and under the merger agreement, it is primarily liable for any obligations of former Southern Pacific.

In *Oswego Falls*, we held that the corporation resulting from the consolidation of three other corporations was primarily liable for any tax deficiencies of the consolidating corporations under New York law, and therefore could not, under State law, be subject to transferee liability. 26 B.T.A. at 69–76. We followed *Oswego Falls* in *Saenger* in holding that the corporation resulting from a consolidation of three corporations under Louisiana law was directly and primarily liable for the predecessor corporations' tax deficiencies as a taxpayer rather than as a transferee. 38 B.T.A. at 1302.[5]

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[4] All statutory references are to the Internal Revenue Code of 1954 as in effect during the years at issue.

[5] In both *Oswego Falls Corp. v. Commissioner*, 26 B.T.A. 60 (1932), affd. 71 F.2d 673 (2d Cir. 1934), and *Saenger v. Commissioner*, 38 B.T.A. 1295 (1938), the amount of liability was not in dispute, only the nature of the liability.

Respondent, on the other hand, argues that *Turnbull, Inc. v. Commissioner*, 42 T.C. 582 (1964), aff'd. 373 F.2d 91 (5th Cir. 1967), is dispositive of whether or not Transportation is a transferee. In *Turnbull, Inc.*, both this Court and the Fifth Circuit held that the successor in a merger was liable as a transferee for the merged corporation's tax deficiencies where the successor obligated itself under the merger agreement and under a transferee agreement (Form 2045) to pay the liabilities of its predecessor, notwithstanding the fact that the pertinent State merger laws imposed primary liability on the successor. Accord *Texsun Supply Corp. v. Commissioner*, 17 T.C. 433 (1951) (holding that the successor in a merger under Louisiana law was a transferee where the successor assumed the merged corporation's liabilities under the merger agreement and had executed a Form 2045).

In the present case, the relevant Delaware statute, like the New York and Louisiana statutes construed in *Oswego Falls* and *Saenger*, provides that the successor corporation in a merger succeeds to, and is liable for, the debts and liabilities of the acquired corporation to the same extent as though incurred by the successor corporation. Del. Code Ann. tit. 8, sec. 259 (1953). There is, however, a distinguishing factor in the case before us that was absent in *Oswego Falls* and *Saenger*. Transportation, like the successor corporations in *Turnbull, Inc.* and *Texsun Supply*, contractually obligated itself under the merger agreement to pay the liabilities of former Southern Pacific. We hold that this factor renders Transportation liable as a transferee at law,[6] regardless of whether or not Transportation, by virtue of the Delaware statute, is also primarily liable for any deficiencies due from former Southern Pacific. We conclude, therefore, that respondent's notice of transferee liability was proper, and that this Court has jurisdiction over Transportation as a transferee.

We note that Transportation's argument proceeds on the premise that one may not be both primarily liable and liable as a transferee. However, in *United States v. Floersch*, 276 F.2d

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[6] Although Transportation did not execute a Form 2045, as was the case in both *Turnbull, Inc.* and *Texsun Supply*, we find that Transportation's assumption of former Southern Pacific's liabilities in the merger agreement sufficient by itself to support our conclusion that petitioner is a transferee at law. We believe that the execution of the transferee agreements in *Turnbull, Inc.* and *Texsun Supply* simply provided additional evidence of the successor corporation's transferee status.

714 (10th Cir. 1960), the Tenth Circuit held that a widow, who received her husband's assets upon his death, could be held liable as a transferee for an income tax deficiency of the husband, even though she was also primarily liable for the deficiency by virtue of having filed a joint return with her husband for the year at issue.

Transportation attempts to read the *Floersch* case as supporting its contention that one cannot have both primary and transferee liability "as to the same assets." It would thus appear that Transportation's argument follows from a mistaken conception of the nature of primary liability. The basis for imposition of primary liability is in no way dependent upon the identity of the obligor's assets. Primary liability is a personal liability that may be satisfied from any or all of the obligor's assets.

Transferee liability, on the other hand, is not a personal liability and only subjects the property or fund, which was received by the transferee from the transferor, to the debts of the transferor. Thus, in certain cases, such as that before us, it is possible for a person to be primarily liable for a transferor's debts and also to be liable as a transferee.

Transportation's second contention, that the notice of transferee liability was barred by the statute of limitations, is not a plea to the jurisdiction of this Court but is a defense in bar. It is not therefore a ground upon which dismissal for lack of jurisdiction may be based. *Badger Materials, Inc. v. Commissioner*, 40 T.C. 1061, 1063 (1963).

Accordingly,

Transportation's motion to dismiss for lack of jurisdiction will be denied.

SOUTHERN PACIFIC COMPANY (FORMERLY S. P. INC.), PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 8648-72. Filed March 12, 1985.

Old SP was the common parent of an affiliated group that filed consolidated income tax returns for the years at issue,

calendar years 1966 through 1968. During 1969, but prior to Nov. 26, 1969, new SP, and its wholly owned subsidiary, SPTC, were formed. On Nov. 26, 1969, a merger occurred in which (1) SPTC received all the assets of old SP, (2) the shareholders of old SP became the shareholders of new SP, (3) old SP was dissolved, and (4) new SP assumed the name of old SP. Respondent was notified on Dec. 2, 1969, of the dissolution of old SP and that SPTC was to act as successor agent for the affiliated group for years ended before the merger.

On Sept. 1, 1972, respondent mailed a statutory notice, determining deficiencies against the affiliated group for the years 1966–68, to new SP as the successor agent for the group. Petitioner filed a motion to dismiss on the grounds that SPTC, rather than new SP, was the successor agent for the group and was the proper entity to receive the statutory notice of deficiency. *Held*: That under the reverse acquisition rule of sec. 1.1502–75(d)(3), Income Tax Regs., new SP became the common parent for the group and was the proper entity to receive the statutory notice of deficiency for the group. The notice was therefore valid, and petitioner's motion to dismiss is denied.

Arnold I. Weber, *Alan S. Beinhorn*, and *William E. Saul*, for the petitioner.

Peter D. Bakutes, *James Booher*, *Vernon R. Balmes*, *Bernard Plamer*, *Lawrence J. Becker*, and *Randall G. Dick*, for the respondent.

OPINION

Background

JACOBS, *Judge*:* This case is before the Court on petitioner's motion to dismiss for lack of jurisdiction. "Petitioners," as the word is used in this opinion, refers to Southern Pacific Co. (formerly S.P. Inc.) and a group of affiliated corporations.[1]

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*By order of the Chief Judge, this case was reassigned from Judge William M. Drennen to Judge Julian I. Jacobs for disposition.

[1]The affiliated companies that joined in the petition are as follows:

Southern Pacific Co. (dissolved 11/26/69)
Holton Inter-Urban Railway Co.
Los Angeles Union Terminal, Inc.
Northwestern Pacific Railroad Co.
Pacific Petroleum Pipe Lines, Inc.
Petaluma & Santa Rosa Railroad Co.
San Diego & Arizona Eastern Railway Co.
Southern Pacific Equipment Co.
Southern Pacific Land Co.

Prior to its dissolution on November 26, 1969, Southern Pacific Co. (hereinafter former Southern Pacific) was a Delaware corporation that had been organized on March 21, 1947, and was the common parent company of an affiliated group of corporations. Southern Pacific Transportation Co. (hereinafter Transportation) was incorporated under Delaware law on February 20, 1969. Sometime before November 26, 1969, S.P. Inc., a newly formed Delaware corporation, acquired the

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Southern Pacific Warehouse Co. (formerly Union Terminal Warehouse)
Monarch Brewing Co.
Nevazona Corp.
Visalia Electric Railroad Co.
Black Mesa Pipeline, Inc.
Southern Pacific Pipe Lines, Inc.
Dallas Smith Service Corp. (liquidated 4/7/69)
Dallas Terminal Railway & Union Depot Co.
Main Street Warehouse Co.
The Southwestern Town Lot Corp.
St. Louis Southwestern Railway Co.
St. Louis Southwestern Railway Co. of Texas
Bankers Leasing Corp.
BLC Corp.
Chattel Leases, Inc.
Commonwealth Control, Inc.
The Commonwealth Plan, Inc.
The Commonwealth System, Inc.
Financial Leasing Corp.
Lease Capital, Inc.
Lease Funds, Inc.
The Midwest Commonwealth Plan, Inc.
The Pacific Plan, Inc.
The Worcester Plan, Inc.
Evergreen Leasing Corp.
Evergreen Freight Car Corp.
Bravo Oil Co.
Texas Town Lot Co.
Louis Heller, Inc.
Pacific Motor Transport Co.
Pacific Motor Trucking Co.
Southern Pacific Transport Co. of Texas and Louisiana (formerly Southern Pacific Transport Co.)
Southwestern Transportation Co.
Southern Pacific Air Freight, Inc.
Southern Pacific Marine Transport Co.
Inter-California Railway Co. (liquidated 7/25/66)

In addition to the above companies, the consolidated returns, filed for taxable years in issue included Nacozari Rail Road Co. (which was liquidated on May 5, 1966), Tijuana & Tecate Railway Co. (the entire stock of which was sold in 1970), and Engineering Enterprises, Inc. (the entire stock of which was sold in 1967).

Southern Pacific Transportation Co. has joined in the petition as the successor in interest to former Southern Pacific Co. and as the designated successor agent for the affiliated group. Southern Pacific Co. (formerly S.P. Inc.) has brought the petition as "the entity to which the statutory notice was addressed."

outstanding stock of Transportation, pursuant to the terms of a merger agreement, dated February 20, 1969, among former Southern Pacific, Transportation, and S.P. Inc. In accordance with the merger agreement, former Southern Pacific transferred all of its assets to Transportation and ceased its separate corporate existence on November 26, 1969. As provided in the merger agreement and pursuant to an amendment to its certificate of incorporation adopted by its board of directors on February 20, 1969, S.P. Inc. changed its name to Southern Pacific Co. (hereinafter new Southern Pacific). The name change took effect on November 26, 1969, the effective date of the merger. Under the merger agreement, the stock of the shareholders of former Southern Pacific was automatically converted into stock of new Southern Pacific. Thus, without any formal surrender of stock certificates, the shareholders of former Southern Pacific, after the merger, became the owners of new Southern Pacific, which had no other shareholders. New Southern Pacific owned all the stock of Transportation which, in turn, owned all the assets of former Southern Pacific.

For all of the years at issue herein (calendar year 1966 through 1968), former Southern Pacific filed consolidated returns for itself and as the common parent agent for its affiliated companies.

In September of 1969, former Southern Pacific and respondent executed Forms 872 extending the period of limitations for assessment of Federal income tax against the former Southern Pacific affiliated group for the years 1962 through 1967 to March 31, 1971. The limitations period for these years was at the time still open.

By letter dated December 2, 1969, the San Francisco District Director was advised that former Southern Pacific had ceased to exist and that Transportation had been designated as the agent of the affiliated group for all relevant taxable years through the taxable year ended December 31, 1968.

In November 1970, renewal Forms 872 were executed for the years 1962 through 1967. Each waiver identified the taxpayer as "Southern Pacific Transportation Company, surviving corporation in merger with, and in its own behalf, and as agent for those corporations, which were members of the Southern Pacific Company affiliated group during the taxable year

below described." The waivers purported to extend the limitations period to September 15, 1971.

In March 1971, another set of Forms 872 were executed, at the instance of respondent, that purported to extend the statute of limitations for the years 1962 through 1965, to June 30, 1972, and for the years 1966 and 1967, to September 15, 1972. These waivers described the taxpayer as "Southern Pacific Company (formerly S.P., Inc.)* successor in interest to Southern Pacific affiliated group for the year indicated below." The asterisk, which was inserted by petitioners, referred to a footnote, also inserted by petitioners, that stated as follows: "See taxpayer's letter of transmittal as to this language." The transmittal letter objected to the designation of new Southern Pacific as the proper entity to execute the waivers.[2]

The notice of deficiency for the years 1966 through 1968 was sent to "Southern Pacific Company (formerly S.P., Inc.), successor in interest to Southern Pacific Company, and common parent of the Southern Pacific Affiliated Group" on September 1, 1972,[3] and forms the basis for the proceeding herein.

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[2]The transmittal letter reads as follows:

Mr. Raymond F. Harless
District Director
Internal Revenue Service
P. O. Box 36040
San Francisco, CA 94102

March 29, 1971

Dear Sir:

Attention: *Mr. Benjamin Lemos*

As orally requested we send you herewith six sets of Form 872, "Consent Fixing Period of Limitation Upon Assessment of Income Tax," extending the period of limitation for the taxable years 1962–1965, inclusive, to June 30, 1972, and for the taxable years 1966–1967, inclusive, to September 15, 1972. For reasons discussed by Southern Pacific Law Department personnel with personnel in the San Francisco Office of Regional Counsel, we think inappropriate the manner in which the "taxpayer" is described in these waivers, and have executed them in their present form only because you have asked that we do so notwithstanding our reservations.

We understand that you wish the present waivers to be executed before March 31, 1971, in order that they may become effective before the waivers executed in September 1969 in the name of "Southern Pacific Company and Members of its Affiliated Group" for the years 1962–1966 expire. Accordingly the present waivers upon execution thereof are to be regarded as superseding the waivers executed in November 1970 for the same years in the name of "Southern Pacific Transportation Company, surviving corporation in merger with, and successor in interest to Southern Pacific Company, in its own behalf, and as agent for those corporations which were members of the Southern Pacific Company Affiliated Group."

(S) H. A. Nelson

[3]In addition to determining deficiencies in the consolidated income tax liabilities of the affiliated group, the statutory notice disallowed refund claims, filed on Sept. 13, 1971, for calendar years 1966 through 1968.

Discussion

Petitioners argue that the petition herein must be dismissed on the ground that respondent failed to direct the notice determining deficiencies in their consolidated income tax liabilities for the years 1966 through 1968 to the proper party. Specifically, petitioners maintain that the determination of deficiencies for the years 1966 through 1968 against new Southern Pacific, as successor in interest to former Southern Pacific and as common parent agent of the affiliated group, was erroneous because new Southern Pacific was not, under the consolidated return regulations, the agent authorized to act for the affiliated group with respect to matters concerning the premerger taxable years of the group. Consequently, petitioners claim that new Southern Pacific is not the proper party against which any deficiency attributable to the years 1966 through 1968 may be determined, and that this Court has no jurisdiction over the members of the affiliated group for the years 1966 through 1968 because respondent failed to direct the statutory notice to the proper agent for the group.

The jurisdiction of this Court can be invoked only by the timely filing of a petition by a taxpayer to whom a notice of deficiency is addressed. Sec. 6213(a).[4] As we pointed out in *Intervest Enterprises, Inc. v. Commissioner*, 59 T.C. 91, 94 (1972), there are at least three prerequisites to this Court's exercise of jurisdiction: (1) A notice; (2) the determination of a deficiency in the notice; and (3) the transmittal of the notice to the taxpayer. In the present case, the controversy is focused upon whether the third of these requirements has been met. The determination of whether this requirement has been satisfied requires consideration of the consolidated return regulations.

As an initial matter, we note that the consolidated return regulations, which have been promulgated under the express authority granted in section 1502, and therefore are legislative in character, underwent a comprehensive revision in 1965 and 1966. B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders 15–51 n. 118 (4th ed. 1979). The revised regulations, which were adopted in final form in 1966,

[4] All statutory references are to the Internal Revenue Code of 1954 as in effect during the years at issue.

T.D. 6894, 1966–2 C.B. 362, 419, are effective with respect to taxable years beginning after December 31, 1965. Sec. 1.1502–0(a), Income Tax Regs. Thus, for the years with which we are concerned in this proceeding, calendar years 1966 through 1968, the revised regulations govern.

A central feature of the provisions of the consolidated return regulations is the role of the common parent as the exclusive agent for the affiliated group with respect to all procedural matters. In delineating the scope of the common parent's agency, the regulations specifically provide that the common parent shall act as agent for all the affiliates for such purposes as receiving deficiency notices, filing refund claims, and executing waivers of the statute of limitations.[5] Sec. 1.1502–77, Income Tax Regs.

Section 1.1502–77(a) of the revised regulations states the following general rule:

> The common parent, for all purposes other than the making of the consent required by paragraph (a)(1) of sec. 1.1502–75, shall be the sole agent for each subsidiary in the group, duly authorized to act in its own name in all matters relating to the tax liability for the consolidated return year. [Emphasis added.]

By its terms, the regulation contemplates that the common parent's authority to act as agent for the affiliated group arises on a year-by-year basis with respect to the group's consolidated income tax liability. Thus, for any given year in which a consolidated return is filed, the entity that is the common parent for that particular year is thereafter the sole agent with respect to any procedural matters that may arise in connection with the group's tax liability for that year.

Obviously, if the existence of the common parent were to terminate after the filing of a consolidated return for a particular year, the agency relationship would terminate, and the group would, in the absence of any provision in the regulations, be left without an agent to act on its behalf in any subsequent dispute over its liability for that year. The regulations, however, address the problem by prescribing the following procedures:

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[5] Petitioners' brief cursorily refers to *Community Water Service Co. v. Commissioner*, 32 B.T.A. 164 (1935), but the issue involved therein is not now before us.

(d) *Effect of dissolution of common parent corporation.* If the common parent corporation contemplates dissolution, or is about to be dissolved, or if for any other reason its existence is about to terminate, it shall forthwith notify the district director with whom the consolidated return is filed of such fact and designate, subject to the approval of such district director, another member to act as agent in its place to the same extent and subject to the same conditions and limitations as are applicable to the common parent. If the notice thus required is not given by the common parent, or the designation is not approved by the district director, the remaining members may, subject to the approval of such district director, designate another member to act as such agent, and notice of such designation shall be given to such district director. Until a notice in writing designating a new agent has been approved by such district director, any notice of deficiency or other communication mailed to the common parent shall be considered as having been properly mailed to the agent of the group; or, if such district director has reason to believe that the existence of the common parent has terminated, he may, if he deems it advisable, deal directly with any member in respect of its liability. [Sec. 1.1502–77(d), Income Tax Regs.]

Petitioners maintain that the December 2, 1969, letter to the District Director satisfied the requirement of notice of designation under section 1.1502–77(d), Income Tax Regs., and that respondent's failure to notify petitioners of any objection to the designation of Transportation as the successor agent at that time amounted to approval of Transportation as the designated agent. Thus, petitioners conclude that Transportation is the properly designated successor agent for the affiliated group for the years at issue and respondent's failure to deliver the notice of deficiency to Transportation deprives this Court of jurisdiction.

In response to petitioners' argument, respondent maintains that the reverse acquisition rule of section 1.1502–75(d)(3), Income Tax Regs., which applies to mergers occurring after October 1, 1965, requires a different result. Respondent contends that, because the 1969 acquisition of all of the former Southern Pacific's assets by the group consisting of new Southern Pacific and Transportation constituted a reverse acquisition under the post-1965 regulations, section 1.1502–75(d)(3)(i)(b), Income Tax Regs., provides not only that the affiliation of the former Southern Pacific group continued uninterrupted after the merger but also requires that new Southern Pacific must be treated as the common parent agent for the group for all years, both before and after the merger. Respondent also argues that, in any event, the designation of

Transportation as the successor agent was invalid under section 1.1502–77(d), Income Tax Regs., and that therefore respondent could properly ignore the designation.

We turn first to respondent's contention that the reverse acquisition rule set forth in section 1.1502–75(d)(3), Income Tax Regs., applies in determining which entity, after a reverse acquisition involving the common parent, is to be treated as the agent for the surviving affiliated group for taxable years before the acquisition.

Section 1.1502–75(d)(1), Income Tax Regs., provides the general rule that an affiliated group is deemed to remain in existence as long as the common parent remains the common parent and at least one subsidiary remains affiliated with it. The regulations recognize three exceptions to the general rule, each of which provides that the affiliated group is still deemed to remain in existence even though the common parent does not remain as the common parent. One of these exceptions is the reverse acquisition rule of section 1.1502–75(d)(3), Income Tax Regs.[6]

The reverse acquisition rule provides that an affiliated group will not terminate where the stock or assets of the common parent are acquired by another corporation in exchange for the stock of that other corporation, provided that the shareholders of the acquired common parent, after the acquisition, own more than 50 percent of the value of the acquiring corporation's stock. Sec. 1.1502–75(d)(3)(i), Income Tax Regs. If the acquiring corporation, before the acquisition, is a common parent of an affiliated group, that group is deemed to terminate even though the acquiring corporation/common parent continues to exist for all purposes except those of the consolidated return provisions. The rule is clearly designed to eliminate the discretion that the shareholders of two merging groups might otherwise have to determine which group survives, given the shareholders' ability to select which parent survives the merger.

Section 1.1502–75(d)(3)(i), Income Tax Regs., further provides that, after the acquisition, the acquiring corporation is to be treated as the common parent of the group that is deemed

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[6] The other two exceptions set forth in the regulations are where the common parent undergoes a reorganization described in sec. 368(a)(1)(F) and where there is a downstream transfer of the common parent's assets. Sec. 1.1502–75(d)(2)(i) and (ii), Income Tax Regs.

to survive the reverse acquisition. Respondent interprets this provision as requiring that the acquiring corporation must be treated as the common parent agent not only for the filing of consolidated returns in post-acquisition taxable years, but also with respect to matters arising in connection with returns filed by the former common parent agent for taxable years that predate the acquisition.

Petitioners, in disputing respondent's interpretation, maintain that the "reverse acquisition" rule only applies to questions regarding continuity of affiliated status and to questions regarding limitations on carryovers. Section 1.1502–77, Income Tax Regs., they contend, exclusively governs the question of which entity succeeds the common parent as agent for the affiliated group.

We disagree with petitioners. We believe that the language in section 1.1502–75(d)(3)(i), Income Tax Regs.—"with the [acquiring] corporation becoming the common parent of the group"—clearly contemplates a metamorphosis of the acquiring common parent into the acquired common parent. Petitioners have not advanced any policy reason for limiting the extent to which the new common parent steps into the shoes of the old common parent under the reverse acquisition rule, and we fail to see any justification for doing so. Indeed, we find that respondent's interpretation has much to recommend it in terms of administrative simplicity. Accordingly, we hold that the reverse acquisition rule applies in determining which entity succeeds the common parent as agent for the affiliated group with respect to years both *before* and *after* the reverse acquisition.

It follows from our view of the scope of the operation of the rule that section 1.1502–75(d)(3), Income Tax Regs., effectively overrides section 1.1502–77, Income Tax Regs., with respect to a determination of the successor agent for preacquisition years following a reverse acquisition. Consequently, we need not consider the parties' arguments under section 1.1502–77, Income Tax Regs., and conclude that the statutory notice for the affiliated group was properly directed to new Southern Pacific, the successor common parent.

Petitioners have also alleged as a ground for dismissal for lack of jurisdiction that the notice of deficiency was in any event barred by the statute of limitations. Petitioners have

since abandoned this argument, recognizing that a claim as to the untimeliness of a deficiency notice is one that requires a determination on the merits and is not a ground upon which dismissal for lack of jurisdiction may be granted. *Badger Materials, Inc. v. Commissioner*, 40 T.C. 1061 (1963). In any event, petitioners' claim as to the untimeliness of the statutory notice is based upon the claim that new Southern Pacific was not the authorized agent of the group, and therefore had no authority to execute the March 1971 Forms 872. Given our holding to the contrary on the agency issue, we would not dismiss the petition on this ground even if untimeliness were considered a proper ground for dismissal for lack of jurisdiction.

Accordingly,

Petitioners' motion to dismiss for lack of jurisdiction will be denied.

DANIEL M. CASTILLO, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 16822–82. Filed March 13, 1985.

Petitioner, a wage earner, failed to file Federal income tax returns for the taxable years 1975, 1976, 1977, and 1978. His Federal income tax liability was underpaid because he filed false Form W-4 certificates with his employer, and because he failed to pay estimated tax. Petitioner was convicted of willful failure to file an income tax return for the taxable year 1977, a violation of sec. 7203, I.R.C. 1954. *Held*, the additions to tax for fraud and failure to pay estimated tax are imposed. *Held, further*, petitioner is collaterally estopped by his criminal conviction under sec. 7203, I.R.C. 1954, from denying that he willfully failed to file a Federal income tax return for the taxable year 1977. *Held, further*, this Court does not have jurisdiction to redetermine the penalty under sec. 6682(a), I.R.C. 1954, for filing false Form W-4 certificates, as the penalty is not attributable to a deficiency. Sec. 6659(a), I.R.C. 1954; *Estate of Young v. Commissioner*, 81 T.C. 879 (1983).

Daniel M. Castillo, pro se.
Mark L. Puryear and *James E. Polk*, for the respondent.

GOFFE, *Judge*: The Commissioner determined deficiencies in petitioner's Federal income taxes for the taxable years 1973, 1975, 1976, 1977, and 1978 and additions to tax under section 6651(a),[1] 6653(a), 6653(b), 6654, and 6682(a) as follows:

Year	*Deficiency*	*Sec. 6651(a)*	*Sec. 6653(a)*	*Sec. 6653(b)*	*Sec. 6654*	*Sec. 6682(a)*
1973	$1,749	$57.79	$87.45	0	0	0
1975	2,600	0	0	$1,300.00	$64.21	$50
1976	3,565	0	0	1,782.50	82.79	50
1977	2,950	0	0	1,475.00	104.61	50
1978	3,973	0	0	1,986.50	95.26	50

After concessions,[2] the issues for decision are: (1) Whether petitioner failed to report income for each of the taxable years 1975, 1976, 1977, and 1978; (2) whether petitioner is liable for the additions to tax under section 6653(b) for underpayment of tax due to fraud, and under section 6654 for failure to pay estimated taxes; and (3) whether this Court has jurisdiction to decide whether petitioner is liable for the section 6628(a) penalty for filing a false Form W-4 certificate with his employer.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and accompanying exhibits are so found and incorporated herein by reference.

Daniel M. Castillo (petitioner) was a resident of Rowlett, Texas, at the time the petition in this case was filed. Petitioner has a high school education and completed 2 years in a trade school for electronics. Petitioner filed Federal income tax returns for the taxable years 1964 through 1972, and for the taxable year 1974. Petitioner has not filed Federal income tax returns for the taxable years 1975, 1976, 1977, and 1978.

Petitioner received taxable income in the amounts of $13,053.66, $15,717.86, $16,677.39, and $17,543.49 for the taxable years 1975, 1976, 1977, and 1978, respectively. Petitioner received W-2 statements from his employer on or about the 31st of January following the close of each taxable year.

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[1] All section references are to the Internal Revenue Code of 1954 and attendant regulations as amended and in effect for the relevant years, and all Rule references are to this Court's Rules of Practice and Procedure.

[2] Petitioner has conceded the deficiency and additions to tax for the taxable year 1973.

Petitioner attended various tax protester meetings during the taxable years at issue. Suggestions made at these meetings were to resist the imposition of Federal income taxation by claiming large withholding allowances on Form W-4 certificates, or by claiming exemption as a minister. Petitioner filed a Form W-4 certificate, dated January 26, 1975, with his employer claiming 18 withholding allowances. Petitioner was not entitled to more than a maximum of four withholding allowances on that date. In April of 1978 and April of 1979, petitioner filed a Form W-4 certificate with his employer claiming that he was exempt from withholding. As a result of these filings, only the minimum Federal income taxes were withheld by his employer during each of the taxable years 1975, 1976, 1977, and 1978.

In May of 1979, Special Agent Jayne Davis of the Criminal Investigation Division of the Internal Revenue Service contacted petitioner at his place of employment in Garland, Texas. Petitioner refused to talk with either Special Agent Davis or her partner at that time. On May 23, 1979, the Criminal Investigation Division received a letter from petitioner requesting a confirmation of his belief that he was not a person required to file an income tax return because he had no income. In a response to petitioner's letter, the District Director of the Dallas, Texas, Office of the Internal Revenue Service, A.W. McCanless, stated that if petitioner desired an interview in private with the Internal Revenue Service that such an arrangement could be made. The response further requested that petitioner contact Special Agent Davis. Petitioner did not contact Special Agent Davis. Petitioner also did not furnish the Commissioner with any information by which petitioner's correct income tax liabilities for the taxable years 1975, 1976, 1977, and 1978 could be determined.

On October 3, 1980, petitioner pleaded guilty to the offense of willful failure to file an income tax return for the taxable year 1977, a violation of section 7203. Petitioner was placed on probation for a period of 3 years, and ordered to pay a fine of $500.

By an undated letter received by the White House on July 20, 1981, petitioner asked President Ronald Reagan for a Presidential pardon for the Federal income taxes and additions to tax owed by him for the taxable years prior to 1979.

The letter claimed that the "people who sincerely believed that they could correct the inequities of the federal income tax system" on the basis of the 16th Amendment to the Constitution were losing their cases because the courts would not allow them to present all of the pertinent cases. Petitioner claimed this as the justification for his guilty plea. Petitioner then requested a pardon on the basis that he did not have the money to pay the taxes and additions to tax, and on the further basis that a clean slate would remove the complication to his wife's records caused by his actions.

On April 12, 1982, the Commissioner timely issued a statutory notice of deficiency to petitioner for the taxable years 1973, 1975, 1976, 1977, and 1978. The Commissioner determined that petitioner failed to file Federal income tax returns for the taxable years 1973, 1975, 1976, 1977, and 1978, failed to pay estimated tax, and filed Forms W-4 containing false information. The Commissioner, after adjustments for rental losses, capital gains, and various deductions and allowances, determined the deficiencies and additions to tax set forth above.

OPINION

The Commissioner's determination in his statutory notice of deficiency is presumptively correct, and petitioner has the burden of disproving each individual adjustment. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a). Petitioner's pleadings and statements at trial are, in essence, a plea for a reduction in the deficiencies and additions to tax asserted, on the basis that he was misguided and misled, and on the further basis that he does not have the money with which to pay these amounts. Petitioner has not contested the amounts determined to be his taxable income for the taxable years 1975, 1976, 1977, and 1978. The Commissioner's determination is, therefore, sustained. Rule 142(a).

The next issue for decision is whether petitioner is liable for the additions to tax under section 6653(b) for fraud. The burden of proving fraud is on respondent, and he must do so by clear and convincing evidence. Sec. 7454(a); Rule 142(b); *Stone v. Commissioner*, 56 T.C. 213, 220 (1971). This burden is met if it is shown that the taxpayer intended to evade taxes known to be owing by conduct intended to conceal, mislead, or otherwise

prevent the collection of taxes, and that there is an underpayment of tax. *Stoltzfus v. United States*, 398 F.2d 1002, 1004 (3d Cir. 1968), cert. denied 393 U.S. 1020 (1969); *Rowlee v. Commissioner*, 80 T.C. 1111, 1123 (1983); *Acker v. Commissioner*, 26 T.C. 107, 112 (1956).

When fraud is asserted, as in the instant case, for more than 1 taxable year, respondent must show that some part of an underpayment was due to fraud for each taxable year for the corresponding addition to tax to be upheld. *Professional Services v. Commissioner*, 79 T.C. 888, 930 (1982); *Nicholas v. Commissioner*, 70 T.C. 1057, 1065 (1978); *Otsuki v. Commissioner*, 53 T.C. 96, 105 (1969). The existence of fraud is a question of fact to be resolved upon consideration of the entire record. *Rowlee v. Commissioner, supra* at 1123; *Gajewski v. Commissioner*, 67 T.C. 181, 199 (1976), affd. without published opinion 578 F.2d 1383 (8th Cir. 1978). Fraud will never be presumed. *Beaver v. Commissioner*, 55 T.C. 85, 92 (1970). Fraud may, however, be proved by circumstantial evidence because direct proof of the taxpayer's intent is rarely available. *Stephenson v. Commissioner*, 79 T.C. 995, 1005–1006 (1982), affd. 748 F.2d 331 (6th Cir. 1984); *Gajewski v. Commissioner, supra* at 200. The taxpayer's entire course of conduct may establish the requisite fraudulent intent. *Spies v. United States*, 317 U.S. 492 (1943); *Gajewski v. Commissioner, supra* at 200; *Stone v. Commissioner, supra* at 223–224.

Respondent has affirmatively shown various indicia of fraud. Petitioner did not file Federal income tax returns for the taxable years 1975, 1976, 1977, and 1978. While the failure to file tax returns, even over an extended period of time, does not per se establish fraud (*Grosshandler v. Commissioner*, 75 T.C. 1, 19 (1980)), the failure to file returns is persuasive circumstantial evidence of fraud. *Marsellus v. Commissioner*, 544 F.2d 883, 885 (5th Cir. 1977); *Stoltzfus v. United States, supra* at 1005. Further, when petitioner's failure to file returns for the taxable years 1975, 1976, 1977, and 1978 is viewed in light of his previous filing of Federal income tax returns for the taxable years 1964 through 1972 and 1974, petitioner's inaction weighs heavily against him.

With regard to the taxable year 1977, petitioner is collaterally estopped by his criminal conviction under section 7203 from denying that he willfully failed to file returns for that

year.[3] *Tomlinson v. Lefkowitz*, 334 F.2d 262, 266 (5th Cir. 1964); *Strachan v. Commissioner*, 48 T.C. 335, 339 (1967); *Amos v. Commissioner*, 43 T.C. 50, 56 (1964), affd. 360 F.2d 358 (4th Cir. 1965).

Petitioner also filed false W-4 Forms to reduce or stop the withholding of Federal income taxes from his wages during the taxable years at issue. Such activities are indicative of an attempt to evade the payment of income taxes. *Rowlee v. Commissioner, supra* at 1125; *Habersham-Bey v. Commissioner*, 78 T.C. 304, 313–314 (1982).

Finally, where a taxpayer's failure to file is predicated on frivolous arguments and where respondent has shown substantial amounts of unreported income on which withholding has been reduced or prevented by the submission of false Form W-4 certificates, we have repeatedly held that fraud has been established by clear and convincing evidence justifying the addition to tax under section 6653(b). See, e.g., *Rowlee v. Commissioner, supra* at 1123–1126; see also *Hebrank v. Commissioner*, 81 T.C. 640 (1983); *Stephenson v. Commissioner*, 79 T.C. at 1007; *Habersham-Bey v. Commissioner, supra* at 313–314. We reach the same conclusion in this case. Accordingly, the Commissioner's determination that petitioner is liable for the additions to tax under section 6653(b) is sustained.

Respondent also determined additions to tax for the taxable years 1975, 1976, 1977, and 1978 under section 6654, for the underestimation of income tax. Where prepayments of tax, either through withholding or by making estimated tax payments quarterly during the course of the year, do not equal the percentage of total liability required under the statute, imposition of the addition is automatic, unless petitioner can show that one of the several statutorily provided exceptions applies. Sec. 6654. The burden to show qualification for such exception is on petitioner. *Grosshandler v. Commissioner, supra* at 20–21. Petitioner made no such showing, and respondent's determination is, therefore, sustained.

The third issue is whether this Court has jurisdiction to determine the imposition of penalties under section 6682(a) for the filing of false W-4 Forms. The Court is a court of limited

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[3] *Pohlman v. Commissioner*, T.C. Memo. 1978–164; *Klee v. Commissioner*, T.C. Memo 1977–149.

jurisdiction. *Estate of Young v. Commissioner*, 81 T.C. 879, 881 (1983); *Medeiros v. Commissioner*, 77 T.C. 1255, 1259 (1981); *Wilt v. Commissioner*, 60 T.C. 977, 978 (1973). Section 6213 confers jurisdiction on this Court to redetermine deficiencies in income, estate, gift, and certain excise taxes. *Estate of DiRezza v. Commissioner*, 78 T.C. 19, 25 (1982). See secs. 6211–6212, 6214–6215. Section 6659(a)[4] sets forth the general rule that the deficiency procedures applicable to income, estate, gift, and certain excise taxes are equally applicable to additions to tax. The imposition of a penalty under section 6682(a) is not, however, a determination based on a deficiency. Section 6682(b) (now sec. 6682(c)) specifically provides that the deficiency procedures shall not apply in respect to the assessment or collection of any penalty imposed by section 6682(a). See sec. 301.6682–1, Proced. & Admin. Regs.; sec. 31.6682–1(b), Employment Tax Regs. Rather, it is an assessable penalty that may be imposed by the Commissioner in addition to any criminal penalty. Accordingly, the deficiency procedures are not applicable, and this Court does not have jurisdiction over the penalty provided in section 6682(a). *Estate of Young v. Commissioner, supra.*

In closing, petitioner's rationale for the nonpayment of Federal income tax for the taxable years at issue is based upon nothing more than the usual, frivolous "protester" arguments. Cases based upon such contentions are burdensome, both to this Court and to society as a whole, as fully discussed in *Abrams v. Commissioner*, 82 T.C. 403 (1984). Should petitioner institute or maintain any future proceedings before this Court in contravention of the provisions of section 6673,[5] we will not

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[4] Sec. 6659(a) is presently codified as sec. 6662(a).

[5] Sec. 6673. DAMAGES ASSESSABLE FOR INSTITUTING PROCEEDINGS BEFORE THE TAX COURT PRIMARILY FOR DELAY, ETC.

Whenever it appears to the Tax Court that proceedings before it have been instituted or maintained by the taxpayer primarily for delay or that the taxpayer's position in such proceedings is frivolous or groundless, damages in an amount not in excess of $5,000 shall be awarded to the United States by the Tax Court in its decision. Damages so awarded shall be assessed at the same time as the deficiency and shall be paid upon notice and demand from the Secretary and shall be collected as a part of the tax.

hesitate to award the maximum amount of damages, even upon our own motion.

Decision will be entered for the respondent except as to section 6682(a), as to which we have no jurisdiction.

ESTATE OF JERRY THOMAS (DECEASED), IMOGENE THOMAS, ADMINISTRATRIX, AND IMOGENE THOMAS, ET AL.,[1] PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 17715–81, 16415–82, 512–83, 1466–83, 1472–83, 1475–83, 1496–83, 1497–83, 1498–83, 1499–83, 1500–83, 1502–83, 5073–83, 9698–83. Filed March 14, 1985.

Held, lessor partnership is true owner of computer equipment for tax purposes; petitioners may not amortize equity placement fee over life of partnership.

Scott F. Cristman, *William D. Eggers*, *Patrick D. Martin*, and *Paul Pineo*, for the petitioners.

Edward D. Fickess, for the respondent.

WHITAKER, *Judge*: This case was submitted fully stipulated pursuant to Rule 122;[2] the stipulation of facts and exhibits attached thereto are incorporated herein by this reference. However, many of the facts set forth herein are based upon our examination of the exhibits and were not set out in the stipulation.

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[1] Cases of the following petitioners are consolidated herewith: Raymond Leven and Nettie Leven, docket No. 16415–82; Robert P. and Janice K. Kuhn, docket No. 512–83; Henry F. and Margaret K. Goller, docket No. 1466–83; Robert C. and Jeanne T. Baesel, docket No. 1472–83; Warren J. and Alice M. Welling, docket No. 1475–83; George E. and Irene L. Schultz, docket No. 1496–83; Roy B. and Dorothy P. Culler, docket No. 1497–83; Neil C. and Marilyn M. Schauf, docket No. 1498–83; James W. and Annie J. Powell, docket No. 1499–83; Elbert W. and Elizabeth C. Phillips, docket No. 1500–83; William L. and Mary S. Albritton, docket No. 1502–83; Edward Waters and Jane C. Waters, docket No. 5073–83; and Bayard C. Tullar and Teresa Tullar, docket No. 9698–83.

[2] Unless otherwise indicated, all Rule references are to the Tax Court Rules of Practice and Procedure and all section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

Respondent determined the following Federal income tax deficiencies:

Docket No.	*Petitioner*	*Year(s)*	*Deficiency*
17715–81	Estate of Jerry Thomas (deceased) Imogene Thomas, administratrix, and Imogene Thomas (The years 1978 and 1979 do not involve the issues here tried.)	1976	$20,449.99
		1977	35,831.08
		1978	23,117.88
		1979	8,761.27
16415–82	Raymond and Nettie Leven	1976	37,874.77
		1977	25,995.20
512–83	Robert P. and Janice K. Kuhn	1976	4,570.62
1466–83	Henry F. and Margaret K. Goller	1976	9,141.00
		1977	4,925.00
		1978	2,325.00
1472–83	Robert C. and Jeanne T. Baesel	1976	4,570.62
1475–83	Warren J. and Alice M. Welling	1976	2,072.90
1496–83	George E. and Irene L. Schultz	1976	4,570.80
1497–83	Roy B. and Dorothy P. Culler	1976	19,042.33
		1977	10,913.36
		1978	4,504.82
1498–83	Neil C. and Marilyn M. Schauf	1976	28,509.00
1499–83	James W. and Annie J. Powell	1976	19,862.73
		1977	10,123.14
		1978	5,611.00
1500–83	Elbert W. and Elizabeth C. Phillips	1976	9,142.00
		1977	5,549.00
		1978	2,374.00
1502–83	William L. and Mary S. Albritton	1976	41,978.00
		1977	26,505.00
		1978	11,678.00
5073–83	Edward and Jane C. Waters	1976	428.00
9698–83	Bayard C. and Teresa Tullar	1976	19,792.00
		1977	10,417.00
		1978	4,029.00

The petitioners in this consolidated proceeding are among the 32 limited partners in a partnership known as 1975 Equipment Investors (Partnership), a limited partnership formed to acquire equipment for lease and/or sale. The pretrial order, dated May 26, 1983, severed for trial, in this proceeding solely

all tax issues arising out of the investment by petitioners in the Partnership. By stipulation, the parties submitted for our consideration only the following: (1) Whether the Partnership is the owner of various items of computer equipment for Federal income tax purposes; and (2) whether amounts paid by the Partnership to E.F. Hutton & Co., Inc. (E.F. Hutton), as an equity placement fee may be amortized over the life of the Partnership.

FINDINGS OF FACT

In Appendix A at the end of this opinion, we set forth the residences of the various petitioners in this proceeding when their petitions were filed and the number of Partnership units owned by them at all material times. Petitioners all were partners in the Partnership, which was formed by the well-known investment firm E.F. Hutton, a subsidiary of the E.F. Hutton Group, Inc. Prior to the activities at issue herein, E.F. Hutton had organized three other limited partnerships which had purchased IBM Systems 370 and 360 computer equipment for lease to a number of corporate lessees and had organized one limited partnership which had purchased a McDonnell Douglas DC-9 aircraft for lease to a commercial airline. E.F. Hutton also had participated as a broker in bringing together prospective lessors and lessees of computer equipment.

Creation of the Partnership

On January 15, 1975, E.F. Hutton formed 1975 Equipment Manager, Inc. (Equipment Manager or the general partner), a Delaware corporation, the sole function of which was to act as general partner of the Partnership. During all material times, Equipment Manager was a wholly owned subsidiary of E.F. Hutton.

The Partnership, a New York limited partnership, also was formed on January 15, 1975, pursuant to article 8 of the New York Partnership Law. As set forth in the amended and restated articles of limited partnership (Partnership agreement), the Partnership was to acquire computer central processing units and related equipment (collectively referred to as equipment), to lease or sell the equipment to others and

to perform any acts to accomplish those purposes.[3] The Partnership agreement provided for a general partner, one class B limited partner,[4] and for the issuance of up to 52 class A limited partnership units. The general partner was to receive a commencement fee of $25,000 in consideration for its services, in addition to a management fee of 2.1 percent of Partnership gross income.[5] The overhead of the general partner was not considered to be an expense of the Partnership. Under the terms of the Partnership agreement, all items of income or loss were to be allocated, and all distributions of cash made, in accordance with each partner's pro rata share. All net cash-flow of the Partnership was to be distributed, first to the general partner to the extent of outstanding advances (plus interest), and thereafter to all partners in accordance with their pro rata shares at the time of distribution. The Partnership life was to commence on the day on which its certificate was filed and to end no later than December 31, 1983.

Offering and Sale of Partnership Interests

In July and August 1975, the Partnership prepared a private placement memorandum (memorandum) to be used for offering limited Partnership interests to selected E.F. Hutton customers. As described in the memorandum, the instant transaction was to be structured as follows: Upon receipt of sufficient capital from prospective investors, the Partnership was to purchase IBM System 370 computers for approximately $9 million by borrowing a substantial portion of the cost of each computer, and immediately thereafter it was to lease the

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[3]The objectives of the Partnership were stipulated to be as follows:

"To borrow a substantial portion of the cost of each IBM System 370 computer; to lease the computers to financially sound lessees for a period of time sufficient to fully repay the borrowings; to realize cash flow during the terms of the initial Leases which was at least sufficient to cover partnership expenses; to permit modest cash distributions to the limited partners beginning in 1976; and to realize the largest possible gain upon either the re-leasing or sale of the computer systems at the expiration of the initial lease terms."

[4]Mr. Donald Sarin, who at all material times was the class B limited partner, was a vice president of E.F. Hutton at the inception of the Partnership. As E.F. Hutton's national coordinator of equipment leasing, Mr. Sarin was responsible for reviewing the investment quality of the instant transaction, marketing the private placement, and supervising the administration of the instant leases. The class B limited partner contributed $500 in cash and received a 0.1-percent interest in the Partnership.

[5]The general partner contributed no cash but received a 1-percent interest in the Partnership.

computers to financially sound lessees for a period of time sufficient to repay fully the borrowings. In order to borrow funds at commercially reasonable interest rates, the Partnership was to pledge both the equipment and the leases as security to the lenders. The memorandum indicated that the Partnership tentatively had arranged to purchase three IBM System 370 computers and lease them to three separate lessees: Sterling Drug Co. (Sterling), Borg-Warner Corp. (Borg-Warner), and Exxon Corp. (Exxon). All of these purchases and leases were arranged through the efforts of equipment brokers, who specialized in IBM computer equipment. The parties have stipulated that, at the time the memorandum was prepared, the Partnership anticipated purchasing and leasing a fourth IBM 370 System, depending on the degree of success of the offering, and the memorandum so indicated. According to the memorandum, during the terms of the initial leases, the Partnership was expected to realize sufficient cash-flow to cover Partnership expenses and to permit modest cash distributions to the limited partners beginning in 1976. It further indicated that, upon expiration of the initial lease terms, the Partnership planned either to re-lease or sell the computers on a basis which would result in the largest possible gain to the Partnership.

Concerning the economic feasibility of investing in the Partnership, each investor was advised in the memorandum to consult his own counsel as to the legal and economic risks and benefits of the investment. It indicated that the investment objectives of the Partnership were:

> To provide an investment opportunity, including
> (a) Maximum use of tax benefits applicable to the Partnership's business, and
> (b) Modest cash distributions to the Limited Partners beginning in 1976, and
> (c) Realization of net cash proceeds upon sale or re-leasing of the computer equipment at the end of the initial leases.

On its face, the memorandum made it clear that investment in the Partnership was only for certain types of investors—those who were able to commit capital for a long-term investment of limited liquidity, who were able to bear the risk of losing their investment, and who were in a position to benefit from the expected tax benefits of the Partnership. Numerous references

are made in the memorandum to taxpayers in the 50-, 60-, and 70-percent brackets, and to the general tax consequences to them of investment in the Partnership. With regard to tax benefits, however, the memorandum cautioned:

> Although the tax benefits anticipated from the Partnership could be said to have the effect of providing a return on investment in the earlier years, tax obligations will arise in later years; the ultimate success of the Partnership will therefor depend upon the profitability of its business and the residual value of the equipment in the later years.

In attempting to provide prospective investors with an assessment of the importance of residual value potential, the memorandum explained that, "on termination of the leases at the end of a projected term of 8 years, unless the computers have a residual value of approximately 14% of the Partnership's original purchase price, the Partnership will suffer an economic loss on the computers." The memorandum declined to predict the expected residual value of the computers, cautiously describing the computer leasing industry as very competitive and emphasizing that price changes and technological obsolescence could have a materially adverse effect upon the Partnership's ability to re-lease or sell the equipment at the end of the lease terms. By the same token, it indicated that risks were minimized, because the models were purchased early in their life cycles.

The following schedule copied from the memorandum contains a calculation of the expected cash-flow to the Partnership based upon the projection of total rental income extrapolated from the three tentatively negotiated leases and the expected expenses:

SCHEDULE II

* * * * * * *

(in thousands)

Taxable year	1975	1976	1977	1978	1979	1980	1981	1982	1983
Rental income	$262	$1,527	$1,527	$1,527	$1,527	$1,527	$1,527	$1,497	$1,123

Disbursements									
Debt service	$62	$1,442	$1,442	$1,442	$1,442	$1,442	$1,442	$1,413	$1,056
Fees and expenses	12	76	76	76	76	76	76	75	60
Applied to equity	188	0	0	0	0	0	0	0	0
Total disbursements	262	1,518	1,518	1,518	1,518	1,518	1,518	1,488	1,116
Cash-flow	0	9	9	9	9	9	9	9	7

Contrary to the projections, the actual cash distributions were zero for all years except 1976, when a cash-flow of $8,897.88 was achieved and $220 per unit distributed.

The net economic effects of an investment in one Partnership unit (assuming that 40 units would be sold and the anticipated leases ran their full terms), without considering the residual value of the equipment at the end of the leases but taking into account tax benefits, were estimated in the memorandum for taxpayers in the 50-, 60-, and 70-percent tax brackets as follows:

SCHEDULE III

Year	Share of partnership profit (or loss)	Share of partnership cash-flow	Net tax savings at 50% plus cash-flow	Net tax savings at 60% plus cash-flow	Net tax savings at 70% plus cash-flow
1975	($28,140)	0	$14,070	$16,884	$19,698
1976	(36,490)	$220	18,465	22,114	25,763
1977	(19,360)	220	9,900	11,836	13,772
1978	(6,480)	220	3,460	4,108	4,756
1979	3,440	220	(1,500)	(1,844)	(2,188)
1980	5,710	220	(2,635)	(3,206)	(3,777)
1981	9,470	220	(4,515)	(5,462)	(6,409)
1982	29,870	220	(14,715)	(17,702)	(20,689)
1983	23,960	170	(11,810)	(14,206)	(16,602)
Totals	(18,020)	1,710	10,720	12,522	14,324

The memorandum then proceeded to quantify the results of the purchase of one $30,000 investment unit, based upon realization of various potential residual values of the equipment which, when added to the net tax benefits and cash-flow indicated above, resulted in the following proceeds:

SCHEDULE IV[6]

If Residual Value Is 20% of Original Cost

	EFFECTIVE TAX RATE		
	50%	*60%*	*70%*
Resulting from operations [From Schedule III]	$10,720	$12,522	$14,324
Cash from sale	39,558	39,558	39,558
Tax on income from sale	14,278	17,133	19,989
Proceeds of investment	36,000	34,947	33,893

If Residual Value of [sic] 15% of Original Cost

	EFFECTIVE TAX RATE		
	50%	*60%*	*70%*
Resulting from operations [From Schedule III]	$10,720	$12,522	$14,324
Cash from sale	29,769	29,769	29,769
Tax on income from sale	9,383	11,260	13,136
Proceeds of investment	31,106	31,031	30,957

If Residual Value Is 10% of Original Cost

	EFFECTIVE TAX RATE		
	50%	*60%*	*70%*
Resulting from operations [From Schedule III]	$10,720	$12,522	$14,324
Cash from sale	19,979	19,979	19,979
Tax on income from sale	4,488	5,386	6,284
Proceeds of investment	26,211	27,115	28,019

In presenting these residual value figures, however, the memorandum again cautioned:

There is not sufficient experience to accurately estimate the residual value of System/370 equipment. Technological obsolescence and the effects

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[6]Despite the fact that the memorandum contemplated the purchase of computer equipment having a total original cost of approximately $9 million (which closely approximates the actual original cost), if all 40 units were sold, the original cost figures used in describing residual value in these tables were closer to $8 million, by our calculation. We know of no reason for the use of these lower figures other than the conservative approach of an offering memorandum.

The stipulated testimony of Warren Wallace, an executive of the general partner, indicates that the residual value percentages of 10, 15, and 20 percent were chosen for illustrative purposes only and not as actual anticipated values.

of inflation are two major variables which make residual evaluation difficult. * * *

The Partnership retained E.F. Hutton to act as its agent in soliciting offers to subscribe to 40[7] class A limited partnership units at $30,000 per unit. Other than the memorandum, E.F. Hutton furnished no sales literature or other written information to prospective limited partners. Through its national brokerage network, E.F. Hutton, acting as the Partnership's exclusive sales agent, successfully raised the full amount of capital ($1,200,500) by selling 40 class A limited partner units to 32 investors. Each type of partner's contribution to, and pro rata share of, the Partnership was as follows:

	Capital	*Pro rata share*
General partner	(none)	1 percent
Class B limited partner	$500	0.1 percent
Class A limited partner	1,200,000	[8]98.9 percent
Total	1,200,500	100.0

This $1,200,500 in cash was disbursed in 1975 as follows:

Paid to IBM for the equipment	$945,673
Paid to equipment brokers	221,154
Paid to E.F. Hutton as equity placement fee	102,000
Paid as formation expenses	20,000
Paid as commencement fee	25,000
Total	[9]1,313,827

The "equity placement fee" referred to above was paid by the Partnership in September 1975. This fee was a sales commission of 8½ percent of the capital raised, which represents a fair and reasonable fee for an offering of this type.

After the offering was completed, the Partnership, through a broker, identified a fourth leasing opportunity with Nissan Motor Corp. (Nissan), and a lease between Nissan and the Partnership was negotiated in November 1975. The projected

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[7] According to the memorandum, the general partner believed it best to refrain from selling the additional 12 units authorized in the Partnership agreement unless it was necessary to finance the purchase of the equipment.

[8] The owner of each class A partner unit owned a 2.4725-percent pro rata share of the Partnership.

[9] The parties have stipulated that in 1975 it was anticipated that the 1975–76 net cash-flow would be used to pay some of these startup and acquisition expenses, although the record does not indicate whether the disbursements in excess of the cash received were in fact paid by means of short-term loans or in some other fashion.

cash-flow on the basis of the four leases is contained in Appendix B at the end of this opinion. The predicted income and expenses of the Partnership during the terms of the four leases (excluding residual value) did not vary significantly from those which had been predicted in the memorandum,[10] and neither prediction anticipated a substantial positive net cash-flow during the lease terms.

The directors and executive officers of the general partner from its formation through 1978 were all executives of E.F. Hutton and were compensated by E.F. Hutton. E.F. Hutton established a separate office and staff[11] in Rochester, New York, to perform the duties of the general partner, including negotiation and administration of the leases with Sterling, Borg-Warner, Exxon, and Nissan. The staff also maintained records reflecting the monthly payment of rent by the various lessees, and the application of these payments to debt service and to the payment of Partnership expenses. These records were reviewed quarterly in connection with the preparation of unaudited quarterly financial statements which were supplied to all limited partners. Audited financial statements were prepared annually and certified by the public accounting firm of Arthur Andersen & Co. The Partnership reported its ownership of the computer equipment to various State and local authorities. The performance of the lessees under the various leases was monitored to assure that the equipment had been properly identified by tags or other means disclosing the Partnership as owner, and that the lessees' required insurance coverage showing the Partnership as an insured was maintained or self-insurance was properly elected.

Leasing and Financing Arrangements

The four lessees each placed orders directly with IBM for the systems they desired and then transferred these orders to the respective brokers or to the Partnership. The Partnership had no role in selecting the equipment packages ordered by the lessees, nor in advising the lessees as to which equipment

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[10] See pp. 417–418 *supra*.

[11] The evidence does not show whether the staff was actually employed and compensated by E.F. Hutton or the general partner, or both. However, it is likely that the general partner was in fact an alter ego of E.F. Hutton and that the separate entity was merely used for bookkeeping purposes.

would be appropriate for their needs. Upon delivery, title was conveyed in three cases from IBM to the brokers and by the brokers to the Partnership; in the fourth case (Nissan), IBM conveyed title directly to the Partnership. The Partnership acquired legal title to each of the systems before the equipment was placed in service by the lessees. The Partnership paid the following amounts to brokers in connection with the lease arrangements:

Alanthus Corp.[12] (Exxon lease)	$92,174.60
Lease Financing Corp.[13] (Sterling lease)	35,900.00
Lease Financing Corp.[13] (Borg-Warner lease)	36,955.00
Unicom Computer Corp.[14] (Nissan lease)	56,125.00
Total	221,154.60

All dealings between the Partnership and the brokers were at arm's length, and broker fees were stipulated to be reasonable in amount.

In accordance with customary industry practices, payment to IBM was made by the Partnership within approximately 30 days after it acquired legal title to the equipment. The Partnership paid fair market value for the equipment. The total purchase price paid by the partnership to IBM for the four computer systems was $9,070,234, paid for by $945,673 of Partnership cash and $8,124,561 of nonrecourse debt, which was secured by the equipment and an assignment of the leases. The financing of the various models of computers at issue here was as follows:

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[12]The Partnership also retained Alanthus Corp. (Alanthus) as managing agent with respect to the Exxon equipment for a monthly fee of $0.0551724 of Exxon rental payments and further retained Alanthus as its exclusive broker for the remarketing of the equipment at the end of the initial lease, with Alanthus' compensation for such services fixed at 4.617 percent of rentals or 5 percent of sales proceeds.

[13]Lease Financing Corp. was not entitled to receive any other payments from the Partnership in connection with either the Sterling or the Borg-Warner equipment, nor did it have any further agreement with the Partnership in connection with this equipment. Nevertheless, it was reasonable to assume that the Partnership would have to pay approximately 5 percent in broker's fees when it tried to sell the equipment.

[14]The Partnership also retained Unicom Computer Corp. (Unicom) as its exclusive broker to assist with the re-lease or sale of the computer equipment upon termination of the Nissan lease. Unicom's fee for these additional services was fixed at 5 percent of the net proceeds. This fee was stipulated to be reasonable in amount.

Exxon (Model 370/168)

First Jersey National Bank	$3,138,000
Wilmington Trust Co.	1,000,000
Partnership capital	470,730
Total cost of system	4,608,730

Borg-Warner (Model 370/3145)

Lease Financing Corp.[15]	$1,145,000
Partnership capital	139,910
Total cost of system	1,284,910

Nissan (Model 370/3158)

Sumitomo Bank of California	$1,953,261
Partnership capital	223,873
Total cost of system	2,177,134

Sterling (Model 370/3145)

Merchants National Bank of Allentown	$888,300
Partnership capital	111,160
Total cost of systems	999,460

The amount of the monthly rental payments to the Partnership under all leases was consistent with rentals for comparable long-term equipment leases. The parties have stipulated that the amount of these rental payments was negotiated at arm's length, and that for each lease, the rental payments were less than those available under third-party operating leases[16] or under leases made directly with IBM. However, the amount also was negotiated with some reference to the cost of equipment and the cost of money required to purchase such equipment. The monthly lease payments to the Partnership and the amounts due monthly from the Partnership to the lenders were as follows:

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[15]First Trust Co. of St. Paul (First Trust), the original anticipated lender, was unable to make a loan to the Partnership when payment to IBM was due for the Borg-Warner computer equipment. Accordingly, the Partnership borrowed the requisite funds from Lease Financing Corp. (LFC) on an interim basis pursuant to an earlier agreement. By Dec. 12, 1975, First Trust purchased the Partnership's promissory note from LFC.

[16]This term is not defined in the stipulation, but on the basis of the record, we assume that an operating lease is one of substantially shorter duration than the leases here.

Lessee	*Monthly lease payment*	*Monthly debt payment*
Exxon	$66,826.00	$61,596.15
Sterling	14,991.00	14,542.69
Borg-Warner	17,453.06	17,167.10
Nissan	33,908.86	32,964.77
Totals	133,178.92	126,270.71

Rentals were to be paid directly to the financing bank, and the banks were directed to apply the rentals to repayment of amounts due from the Partnership, to remit to Alanthus its brokerage fees (in the case of Exxon), and in all four cases, to pay the excess to the Partnership. All four leases were "net leases" in a form commonly used in the industry. The lessees were responsible for all fees and taxes incurred in connection with the equipment (excluding income taxes payable by the lessor), and were required to keep the equipment insured at their expense. The lessees also were required to maintain the equipment at their expense and to keep in force an IBM maintenance agreement (or, in the case of Exxon, an equivalent maintenance agreement) with respect to the equipment. Two of the leases expressly state that title to the equipment at all times remained with the lessor, and it is stipulated that the lessees had no rights to interests in the equipment except as lessees under the four leases in the record.

The lessor was not responsible to the lessees for the consequences of defects in, damage to, or loss or destruction of the equipment. In the event of repairable damage to the equipment, the lessees were required to repair it at their own expense. In the event of damage beyond repair, the lessees were required in one case, to replace the equipment, in two of the others, to pay the lessor a casualty loss value (which was specified in schedules to the leases as a percentage of equipment cost, such percentage declining slightly each month), and in the fourth case, to pay the greater of the casualty loss value (which was specified as a lump-sum dollar value that declined each month) or the full replacement cost.

All four of the lessees had options to terminate their leases prior to expiration of the initial lease periods, subject to payment of stated termination payments also set forth in schedules attached to the leases. One of these schedules recited specific lump-sum dollar values, and the others expressed the

termination values as a percentage of original cost. Termination was only permitted after the passage of 5 months in the case of the Exxon lease, 39 months in the cases of the Sterling and Borg-Warner leases, and 52 months in the case of the Nissan lease. Termination payments and casualty payments were, on all dates set forth in the schedules, more than sufficient to pay off all Partnership debts with respect to the computers subject to the leases. In two cases, in the event that a lessee decided to terminate, the lessor and lessee were to use their best efforts to sell (and in one case to sell or re-lease) the equipment subject to the terminated lease, and the lessee was only required to pay the amount, if any, by which the termination value exceeded the highest offer. If no offer was made, the terminating lessee had to pay the full termination penalty,[17] whereupon the lease obligations would cease, and the lessor was free thereafter either to re-lease or sell the equipment. In the two other cases, the lessor was required to sell the equipment for the highest cash offer and refund the proceeds (less the selling expenses) to the terminating lessee.

In three of the leases, the lessees had options to purchase or re-lease the equipment under the leases at the end of the initial lease terms. Such options required the payment of fair market value or fair market rent, as of that date, to the Partnership. No lease contained a provision obligating the lessee to purchase or re-lease the equipment at the end of the respective lease term. In the absence of such renewal or purchase, upon expiration of each lease, the lessees were obligated, at lessees' expense, to deliver the equipment to a location to be specified by the Partnership. The leases were scheduled to terminate on the following dates:

Exxon	October 1983
Sterling	Nov. 30, 1982
Borg-Warner	Nov. 1, 1983
Nissan	Dec. 1, 1982

As required by the lease terms, the Partnership filed appropriate elections, and the lessees claimed all available tax credits in connection with the equipment.

[17] Under its initial lease, Exxon's termination payments were guaranteed by Alanthus, to a degree.

Pursuant to the terms of its lease, Exxon, one of the lessees, had the right to request the lessor to purchase and lease to Exxon any IBM model upgrades or features for its system, provided appropriate terms could be negotiated. By reason of that lease provision, in late 1976 and mid-1977, two sets of upgrade equipment were leased to Exxon.

In August 1978, because of IBM price reductions, Exxon decided to terminate its lease unless rental payments were reduced. In the event of early termination, the Partnership would have received rental income in a substantial lump sum from the termination payments. In the event that such termination resulted in the sale of the equipment, substantial recapture of depreciation would have occurred. In order to avoid these adverse tax consequences, a restructured lease was entered into in September of that year which extended the old lease term until September 15, 1985, and reduced Exxon's monthly rental on both the original equipment and the two upgrades from $73,476 to $60,000. Under the restructure, Alanthus was not entitled to any brokerage fees and assumed the full economic risks of termination payments. In connection with the renegotiation of the Exxon leases, the Partnership restructured its debt by borrowing $3,335,571.91 from a bank and paying off the earlier loans obtained in connection with the equipment leased to Exxon. The monthly payments on the new debt were equivalent to Exxon's new rental payment to the Partnership.

Residual Value

During this period of time, the obsolescence of computer equipment occurred primarily as a result of technological advances. Thus, for purposes of this case, the rate of obsolescence or diminishing value is directly related to the rate of introduction of new, technically advanced equipment models. During these years, IBM was the primary factor influencing the prices for used IBM computer equipment. IBM announcements about new products or price changes usually had an immediate impact on the market values of used IBM computers.

In the early 1960's, IBM had a major impact on the computer world with the announcement of the IBM 360 family of computers. This product line was a drastic departure from

previous offerings in that it combined into a single family unit what had been previously a conglomeration of several different models. For a long time thereafter, it appeared that IBM's pace of new products and pricing policies were stable and relatively predictable. IBM tended to announce major generations of new computers at intervals of 5 to 6 years.

In 1971, IBM introduced the first models of the System 370, which provided increased internal processing speed and data storage capacity, resulting in a lower cost per unit of work processed as compared to the System 360. The IBM System 370 Model 168, which was leased to Exxon, was announced in 1972 as the successor to an earlier model of the System 370. A high-end virtual storage machine, it provided cost savings and operational advantages over its predecessor and became quite popular with very large advanced users. The IBM Model 3158, leased to Nissan, also was one of the larger members of the 370 series. It was announced in 1972 and was a successor to the System 370 Model 155,[18] becoming available in April 1973. IBM Model 3145 units were leased to Sterling and Borg-Warner. That model was a medium sized, general purpose computer with advanced memory capabilities. This advanced version was announced in February 1973.

During the early 1970's, internal IBM documents had indicated a plan for a "Future System" (FS). It was generally known in the industry that the FS was expected to be another dramatic departure from earlier IBM trends, similar in scope to the differences between the Model 360 and earlier families. However, by May 1975 many in the field believed that IBM was going to cancel the FS program, and this knowledge had a buoying effect on the residual value predictions of many experts at the time.[19] By October 1976, it was clear that IBM had abandoned the FS and that future changes in IBM's product lines would be "evolutionary" rather than "revolu-

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[18]The Model 155 was found in *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184 (1983), affd., revd., and remanded 752 F.2d 89 (4th Cir. 1985), to be "trailing behind new technology" when acquired in 1975. 81 T.C. at 190.

[19]We note that the expert's report presented by Frederic G. Withington in this proceeding was based upon an earlier report that he had prepared for Arthur D. Little, Inc., in May 1975. In that earlier report he did not base his predictions of residual value upon abandonment of the FS; to the contrary, he appears to have presupposed its introduction. Given the proximity in time, we do not view this testimony as inconsistent with our finding but instead attribute the discrepancy to the fact that the report may have been prepared prior to the dissemination of rumors about IBM's abandonment of the FS program or to Mr. Withington's more conservative approach.

tionary." As it actually turned out, however, IBM in January 1979 announced a completely new line of computers, the IBM Model 4300, which had a profound effect on the computer industry and rendered obsolete prior predictions concerning residual values of used IBM 370 models.[20]

Those E.F. Hutton executives who were concerned with the instant transactions were familiar with computer equipment, and with equipment leasing transactions and residual value projections in connection therewith.[21] From their familiarity with those projections, they expected in 1975 a minimum residual value range for the instant equipment of 15 to 20 percent and believed that expectations of as high as 30 percent were reasonable.[22]

We find these estimates to be thoroughly reliable, reasonable, and confirmed by the evidence in the record as a whole.[23]

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[20]In addition to being far superior in price and performance, the 4300s were much less expensive to operate than their predecessors. Consequently, the 370 models declined in value at a much faster rate than had been predicted by many forecasters, since the introduction of this new model had been unexpected.

[21]We note that this case thus is in sharp contrast to the situation presented in *Brannen v. Commissioner*, 78 T.C. 471 (1982), affd. 722 F.2d 695 (11th Cir. 1984), where the transactions were handled in a "nonbusinesslike manner" (78 T.C. at 508, 510). See note 22 *infra*.

[22]Warren F. Wallace, one of the E.F. Hutton executives, had prior to the instant transaction been actively involved in the formation of computer leasing partnerships. As an E.F. Hutton executive, he was directly involved in identifying investment opportunities for E.F. Hutton customers. In connection therewith, he had become familiar with projections of residual values of IBM computer equipment by well-informed outside sources. Part of his optimism concerning potential residuals was due to the possibility that IBM's upcoming models would be compatible with the System 370 models. He also recognized that there was a chance that residual value could fall below 15 percent. On the basis of his experience and investigations, he believed that the Partnership's leasing arrangements made good economic sense, apart from tax considerations. Mr. Wallace based this conclusion in the additional facts that short lease terms would be used, the lessees would be financially sound, and that risks would be further minimized by the use of more than one lessee.

[23]A Stanford Research Institute study prepared in February 1975 indicates that between 10 and 11 years from market introduction, the market value of a central processing unit is likely to be approximately 17 to 18 percent of selling price, although the study emphasized that these figures were averages of fluctuating prices. Because responsible representatives of the general partner indicated familiarity with residual value projections in 1975 (see note 22 *supra*), it is likely that this study was known to them when they structured the instant transaction.

Mr. Withington, who testified for respondent in *Rice's Toyota World, Inc. v. Commissioner*, *supra*, predicted in May 1975 that, even with the advent of the FS capabilities looming on the horizon, the instant models, when weighted according to the original list cost of each system over original list total costs, could be expected to have residual values of between 9 and 18 percent of cost. Mr. Withington's prediction is the most conservative one in the record. See note 19 *supra*.

Two other witnesses, Hartmann and Lyons, testified that in August 1975, they expected residual values of the instant models of equipment to be between 20 and 30 percent by 1982 or 1983. Respondent presented no evidence to indicate that such expectations were unrealistic, merely contending on brief that Mr. Hartmann valued a more expensive computer in one instance. Even if we accept this contention, Mr. Hartmann's overall weighted residual value, expressed as a percentage of original list cost, would have exceeded 20 percent.

The parties have stipulated that, as of August 1975, it was reasonable to expect the equipment to have remaining useful lives of at least 3 years at the end of the initial leases, and that it also was reasonable to expect that the aggregate residual value of all equipment owned by the Partnership at the end of the lease terms would be at least 14 percent of the overall expected cost of that equipment. A 14-percent residual value based upon an original cost of approximately $9 million (indicated in the memorandum to be the equipment's total expected cost) would have generated approximately $1,260,000.[24] When this amount is added to the total cash-flow predicted in the memorandum during the terms of the leases of approximately $70,000, a 14-percent residual value would have produced something very close to a breakeven for the Partnership after 5 percent in broker's fees for selling the equipment[25] is taken out.[26] A 20-percent residual value would have produced a pre-tax profit to the Partnership of $580,000.[27]

The fact that some 4 years later the bottom fell out of the used computer market does not alter the reasonable nature of the predictions in August 1975. The higher predictions were made in part in reliance upon continued high anticipated levels of inflation[28] and IBM's historically slow and steady advancement in the field. Rumors that the Future System would be abandoned encouraged many to believe that, since models likely to be introduced by IBM in the future might be compatible with the 370 models, the residual values of those models would be substantial. Moreover, in January 1975, IBM announced an 8-percent increase in the price of new 370 computers. Residual values were generally expressed as a

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[24] The parties have stipulated that a residual value of 14 percent *or $1,300,000* was reasonably expected, but since 14 percent of $9 million is $1,260,000, we have not been able to discern the derivation of $1,300,000.

[25] See notes 12–14 *supra*.

[26]

$9 million × .14 =	$1,260,000
plus cash-flow expected in memorandum	70,000
less broker's fee (5% × $1,260,000)	(63,000)
less total amount invested	(1,200,000)
Total partnership profit	67,000

[27]

$9 million × .20 =	$1,800,000
plus cash-flow expected in memorandum	70,000
less broker's fee (5% × $1,800,000)	(90,000)
less total amount invested	(1,200,000)
Total partnership profit	580,000

[28] The Consumer Price Index rose by 11 percent in 1974.

percentage of the current IBM list price at the time of the residual value prediction; therefore, expected increases in list prices understandably would result in even higher expected residual values when expressed as percentages of original costs.[29] Accordingly, in view of the fact that the Partnership was expected to break even if a 14-percent residual value were achieved and that contemporaneous predictions indicated that a 20- to 30-percent residual value was reasonably possible, there was a reasonable expectation of profit accruing to the Partnership by the end of the lease terms. Thus the Partnership entered into the activity with the requisite profit objective.

The Partnership reported its income and expenses on a cash basis. Income consisted primarily of gross rental receipts received under the leases. Expenses included depreciation, management fees, amortization of brokerage fees and deferred costs, State sales tax, interest, and miscellaneous administrative expenses. The equity placement fee paid to E.F. Hutton—which is in issue—was amortized over a 9-year period. On its Federal income tax returns (Forms 1065) for 1975 through 1982, the Partnership reported the following:

Year	*a. Partnership income (loss)*	*b. Investment interest expense*	*Total (a - b)*
1975	($1,196,028)	- - -	($1,196,028)
1976	(769,227)	$709,659	(1,478,886)
1977	(187,717)	670,610	(858,327)
1978	289,241	657,678	(368,437)
1979	158,447	509,064	(350,617)
1980	543,806	405,665	138,141
1981	875,538	302,965	572,573
1982	2,354,890	182,071	2,172,819

The income or loss per class A limited Partnership unit resulting from those amounts was as follows:

Year	*Profit (loss)*
1975	($29,572)
1976	(36,565)
1977	(21,222)

[29] For example, if the price of a computer on the date of a predicted 20-percent residual value was $100, a residual value of $20 would be expected. However, if that list price were to increase subsequently to $150, the expected 20-percent residual value would be $30, which constitutes 30 percent of the original actual cost.

Year		*Profit (loss)*	
1978		($9,110)	
1979		(8,669)	
1980		3,416	
1981		14,157	
1982		53,723	
1983	[30](estimated)	23,960	
Total		(9,882)	Net loss

Petitioners reported their shares of these amounts on their returns for some or all of the years 1976, 1977, 1978,[31] and respondent disallowed petitioners' shares of Partnership losses and investment interest expense deductions[32] stating, inter alia, either that it had not been established (1) that a deductible loss had been sustained by the Partnership or (2) that the petitioners or the Partnership was the owner of the subject equipment because they had not incurred the benefits and burdens of ownership and thus the leases were not true leases. If the Partnership is determined to be the true owner of the equipment, respondent asserts that amounts paid for the equity placement fee to E.F. Hutton constitute a capital asset that may not be amortized.

OPINION

Partnership's Ownership of Equipment

The first question to be addressed is whether the Partnership is correctly viewed as the owner of the equipment for tax purposes. Petitioners take the position that the Partnership is the owner because it bore the benefits and burdens of ownership. While there was expected to be little positive net cash-flow to the Partnership during the lease periods, and little risk that lease payments would not fully amortize the debt in connection with the equipment, petitioners contend the Part-

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[30]The Partnership return for 1983 is not part of the record, since the trial occurred before the end of the calendar year. We have used, therefore, the predicted figure in the memorandum (which is contained in Schedule III, reproduced at p. 418 *supra*).

[31]In the case of petitioners in docket No. 1499–83, different amounts were reported on the 1977 and 1978 returns, despite the reporting of correct amounts by the Partnership on the Form K-1 supplied to petitioners. There also appears to be a small error in the reporting of the investment interest expense deduction in docket No. 5073–83.

[32]In docket No. 1475–83, respondent disallowed only petitioners' share of Partnership losses for 1976, apparently because petitioners did not deduct any Partnership investment interest expense on their return, unlike all of the other petitioners before us.

nership at all times retained legal title and the right to the equipment's residual value at the end of the lease terms. Thus, it is argued, the Partnership bore the risk that its initial cash outlay of $1.2 million could be lost entirely, and it also possessed a reasonable opportunity for profit, in that the residual value could be substantially in excess of the cash investment.

Respondent's position is that the instant equipment leasing transaction is merely a tax-avoidance scheme, and that the Partnership's ownership of the equipment should be disregarded for tax purposes. In support of this position, respondent urges three legal tests: (1) The leasing arrangements do not satisfy the tests of substance established by the Supreme Court in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); (2) the Partnership did not acquire the benefits and burdens of owning the equipment; and (3) the Partnership did not assume the substantive risk of loss of value. Respondent's conclusion therefrom is that the true characterization of these transactions is either a financing arrangement or a sale of the equipment by the Partnership to the lessees. Respondent focuses principally upon the contention that the instant transaction was intended merely to break even, so that petitioners were merely purchasing tax writeoffs. We view respondent's three arguments as essentially interconnected. Fundamentally, respondent contends that the Partnership's ownership of the equipment was so devoid of economic substance that it should be disregarded.

In ascertaining the proper characterization of the Partnership's interest, the parties' characterization of the form of the transaction should be respected so long as the lessor retains significant and genuine attributes of a traditional lessor. *Frank Lyon Co. v. United States, supra* at 585. The existence of tax benefits accruing to its investors does not necessarily deprive a transaction of economic substance. *Frank Lyon Co. v. United States, supra* at 574, 581; *Commissioner v. Brown*, 380 U.S. 563, 579–580 (1965) (Harlan, J., concurring); *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184, 196 (1983), affd. on this issue 752 F.2d 89 (4th Cir. 1985); *McLane v. Commissioner*, 46 T.C. 140, 145 (1966), affd. per curiam 377 F.2d 557 (9th Cir. 1967), cert. denied 389 U.S. 1038 (1968). But where the transactions were entered into without any economic purpose

other than favorable tax consequences, the courts have appropriately disregarded the form. E.g., *Knetsch v. United States*, 364 U.S. 361 (1960); *Higgins v. Smith*, 308 U.S. 473 (1940); *Gregory v. Helvering*, 293 U.S. 465 (1935); *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981); *Derr v. Commissioner*, 77 T.C. 708 (1981); *Hager v. Commissioner*, 76 T.C. 759 (1981); *Narver v. Commissioner*, 75 T.C. 53 (1980), affd. per curiam 670 F.2d 855 (9th Cir. 1982); *Beck v. Commissioner*, 74 T.C. 1534 (1980), affd. 678 F.2d 818 (9th Cir. 1982); *Estate of Franklin v. Commissioner*, 64 T.C. 752 (1975), affd. 544 F.2d 1045 (9th Cir. 1976).

Respondent's position that the instant transaction in reality was a sale is necessarily predicated upon the theory that the equipment would be effectively "used up" so that there would be nothing to be returned by the lessees to the Partnership at the end of the lease terms. This perception is, however, belied by the stipulation and the evidence before us. The parties have stipulated that the computers were expected to have a useful life of at least 3 years beyond the lease terms and that a residual value of at least 14 percent was reasonably expected, which amount would have enabled the Partnership to recoup its original cash investment and to break even. The record as a whole, moreover, supports a reasonable potential for considerably higher residual values—as much as 30 percent.[33] Thus, as we have found, the Partnership engaged in the activity with the objective of making a profit.[34]

Moreover, there is no dispute that the Partnership at all times retained its rights as owner of the equipment. While the Partnership did contract away a number of risks with respect to the equipment, net leases are commonly used today and do not necessarily reflect an absence of ownership. See *Hilton v. Commissioner*, 74 T.C. 305, 348 (1980), affd. per curiam 671 F.2d 316 (9th Cir. 1982), cert. denied 459 U.S. 907 (1982); *LTV Corp. v. Commissioner*, 63 T.C. 39, 49–50 (1974). Similarly, the

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[33] See notes 22–23 and accompanying text *supra*.

[34] Respondent contends that residual value is only one factor among many to be examined in determining whether there was an opportunity to make a profit. In support thereof, he cites *Beck v. Commissioner*, 74 T.C. 1534 (1980), affd. 678 F.2d 818 (9th Cir. 1982). In that case, we did not indicate that residual value was insignificant; rather, we held that subsequent events resulting in unexpected profits did not generate economic substance where the sales resulting in those profits were not arm's-length transfers, but mere manipulations to create a paper profit. 74 T.C. at 1558–1562. We concluded, therefore, that the indebtedness by far exceeded the fair market value of the property so that the debt could not be included in basis. Such obviously is not the case here.

absence of significant positive net cash-flow during the lease terms is a neutral factor. See *Hilton v. Commissioner, supra.* On the other hand, the Partnership did retain a significant benefit and burden with respect to the equipment—that residual value would either generate a profit or a loss.[35]

Consequently, there is no basis for concluding that the lessees acquired an equity in the instant equipment.[36] The lease terms were substantially shorter than the equipment's useful lives, as the parties have stipulated, which is characteristic of a lease. See, e.g., *Bowen v. Commissioner*, 12 T.C. 446, 459 (1949); *Holeproof Hosiery Co. v. Commissioner*, 11 B.T.A. 547, 556 (1928).[37] Reasonable rental payments, such as those here, also are indicative of a bona fide lease in that they are not likely to be payments by the lessee for purchase of equity in the property. See *Frank Lyon Co. v. United States*, 435 U.S. 582 (1978); *Oesterreich v. Commissioner*, 226 F.2d 798, 803 (9th Cir. 1955), revg. a Memorandum Opinion of this Court; *Belz Investment Co. v. Commissioner*, 72 T.C. 1209 (1979), affd. 661 F.2d 76 (6th Cir. 1981); *Haggard v. Commissioner*, 24 T.C. 1124, 1128 (1955), affd. per curiam 241 F.2d 288 (9th Cir. 1956). The parties' treatment of the leases as such on their books and records—including treatment of lease payments by at least some of the lessees as deductible business expenses—is an additional factor indicating a bona fide lease. See *Benton v. Commissioner*, 197 F.2d 745, 753 (5th Cir. 1952).

Upon conclusion of the leases, the equipment was to be physically returned to (or as directed by) the Partnership. In the three instances where the lessees had options to purchase or re-lease, the lessees were required to pay fair market value or rental. Cases which hold that equity is being transferred to a lessee in instances where exercise of an option to purchase is inevitable because the option price is nominal or small are simply not in point here. See *American Realty Trust v. United States*, 498 F.2d 1194, 1199 (4th Cir. 1974); *Oesterreich v.*

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[35] We note that, even though some of petitioners' cash investment could be said to have been expected to be recouped by means of tax benefits in the early years, the expected net tax benefits over the 9-year period, if coupled with a very low residual value, would have resulted in an out-of-pocket loss for investors.

[36] The lessee acquires an equity when he acquires something of value in relation to the overall transaction, other than the mere use of the property. *Judson Mills v. Commissioner*, 11 T.C. 25, 32 (1948); *Reade Mfg. Co. v. Commissioner*, T.C. Memo. 1973-259.

[37] See also *Davis v. Commissioner*, T.C. Memo. 1978-348.

Commissioner, supra; *Belz Investment Co. v. Commissioner, supra.*[38] See also *Smith v. Commissioner*, 51 T.C. 429, 439 (1968) (exercise of option compelled by agreement with third party). In *LTV Corp. v. Commissioner, supra*, we rejected respondent's argument that the existence of an option to purchase indicated a conditional sale, because the option price was "comparable with the computer's estimated fair market value at the end of the lease term." 63 T.C. at 50.[39]

The facts here are distinguishable from those in *Swift Dodge v. Commissioner*, 76 T.C. 547 (1981), revd. 692 F.2d 651 (9th Cir. 1982), where our holding that the lease agreements before us were not in fact conditional sales contracts was reversed by the Court of Appeals. While in some respects the obligations and rights of the lessee, there, resemble those of the lessees, here, the crucial distinction—and an important ground for the Court of Appeals' reversal of our decision—was that the *Swift-Dodge* leases were "open-ended": The lessee at lease end was required to pay the lessor the amount, if any, by which the "depreciated value" (set forth in the lease) exceeded its actual value; in the event that the actual value exceeded the depreciated value, the lessee received the difference. Thus, the Court of Appeals concluded, the lessee assumed the risk of depreciation, and the arrangement in reality was a conditional sale. 692 F.2d at 654. In contrast, the leases here were closed-ended in that the Partnership bore the risk at the end of the leases that the residual value would not be sufficient to recoup its cash outlay. At the same time, the Partnership possessed the potential for gain if residual values exceeded its investment. See *Swift Dodge v. Commissioner*, 76 T.C. at 568–569 n. 11.[40] For similar reasons, our decision in *Leslie Leasing Co. v. Commissioner*, 80 T.C. 411 (1983), likewise is distinguishable.

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[38] See *Reade Mfg. Co. v. Commissioner*, T.C. Memo. 1973–259; *Beaudry v. Commissioner*, T.C. Memo. 1972–214.

[39] See also *Cal-Maine Foods, Inc. v. Commissioner*, T.C. Memo. 1977–89 (absence of provision that a portion of the monthly payments would be credited against option price was factor indicative of lease).

[40] We stated in our opinion in *Swift Dodge v. Commissioner*, 76 T.C. 547 (1981), revd. 692 F.2d 651 (9th Cir. 1982), that the risk of residual value fluctuation is only one factor among many to be considered in deciding the lease-versus-sale question, but there were a number of factors that mitigated the lessees' assumption of that risk in that case. 76 T.C. at 569, 574. In contrast, we believe that the Partnership's assumption of the residual value risk here is of controlling significance on the facts currently before us. Consequently, we need not decide whether we should follow our opinion or that of the Court of Appeals in *Swift Dodge*.

Nor are we persuaded by respondent's contention that the fact that the Partnership's debt obligations would be extinguished at lease end shows that a sale was intended. This Court has upheld lease transactions where total rentals over the lease terms equaled or even exceeded the total cost of the equipment. E.g., *Kansas City Southern Railway Co. v. Commissioner*, 76 T. C. 1067, 1102–1103 (1981). Rent during an initial lease term geared to the cost of interest and mortgage amortization is not, in and of itself, much more than a neutral commercial reality. *Dunlap v. Commissioner*, 74 T.C. 1377, 1436 (1980), revd. on another issue 670 F.2d 785 (8th Cir. 1982); *Hilton v. Commissioner*, 74 T.C. 305, 348 (1980), affd. per curiam 671 F.2d 316 (9th Cir. 1982), cert. denied 459 U.S. 907 (1982).

With regard to respondent's "financing arrangement" theory, we see little to distinguish this case from *Frank Lyon Co. v. United States*, *supra*, where the Supreme Court upheld the form of a transaction structured very similarly to the one before us but in some respects not as strongly indicative of a lease transaction. For example, in this case the lessor's initial equity ($1.2 million) represented approximately 13 percent of the equipment's total cost ($9,070,234), whereas in *Frank Lyon*, it represented about 6 percent. The potential lease term in *Frank Lyon* aggregated 65 years, which probably was close to the useful life of the building; here, the lease terms were only 8 years, and the computers were expected to have useful lives of at least 3 years beyond lease termination. In *Frank Lyon*, the renewal rental was fixed at approximately one-half of the initial term, whereas, here, renewal rental was at fair market rent. Consequently, even more than in *Frank Lyon*, the Partnership, here, retained "significant and genuine attributes of the traditional lessor status." 435 U.S. at 585.

In addition, the tests of substance set forth in *Frank Lyon* are met here. Respondent argues that the fact that the notes are nonrecourse evidences a lack of true substance, but, contrary to respondent's contentions, we have stated repeatedly that we do not believe that the nonrecourse nature of notes is necessarily more than a "neutral factor," since nonrecourse liabilities are commonly used in modern transactions.[41] See

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[41] We note that we are not presented here with the situation typical of many tax shelter proceedings where the purchase price of the property or the nonrecourse liability was substantial-

Dunlap v. Commissioner, *supra* at 1435; *Hilton v. Commissioner*, *supra* at 363.

The "business reality" presented to the Partnership was a potential for profit upon realization of residual value at the end of the lease term.[42] The business purpose to the lessees,[43] at least in part, appears to involve the fact that the rent paid to the Partnership was less than that which would have been paid to IBM if the equipment had been rented directly from IBM. Moreover, as respondent concedes, the lessees were spared the capital investment, which is true with any lease. While respondent contends that the lessees could have purchased the equipment themselves, either outright or by means of debt financing, this sort of speculation is not appropriate to our analysis. As the Supreme Court said in *Frank Lyon*, "a transaction must be given its effect in accord with what actually occurred and not in accord with what might have occurred." 435 U.S. at 577.

But most importantly, the two interrelated remaining factors enunciated by the *Frank Lyon* Court—that the transaction contain "economic substance" and be "imbued with tax-independent considerations"—have been met here. As we have already discussed, there was a reasonable potential for profit which clearly constitutes the requisite substance. Unlike respondent, we find the emphasis in the private placement memorandum upon tax benefits expected from investment in the Partnership to be reasonable and normal under the circumstances. As we have noted, the existence of tax benefits does not necessarily deprive a transaction of economic substance. Moreover, the absence of any concrete assurances of profit to the investors does not indicate to us that no profit was intended. Rather, this reflects the conservative requirements of securities laws. Similarly, the Exxon restructure—whereby the Partnership avoided the depreciation recapture and income realization that would have occurred in the event of

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ly in excess of the property's fair market value. See, e.g., *Odend'hal v. Commissioner*, 80 T.C. 588 (1983), affd. 748 F.2d 908 (4th Cir. 1984); *Brannen v. Commissioner*, 78 T.C. 471 (1982), affd. 722 F.2d 695 (11th Cir. 1984); *Estate of Franklin v. Commissioner*, 64 T.C. 752 (1975), affd. 544 F.2d 1045 (9th Cir. 1976). See note 49 and accompanying text *infra*.

[42] As we noted in our findings, the parties stipulated that the Partnership's "business purpose" was to acquire and lease the equipment "and, at the end of these initial leases, to re-lease, sell or exchange the equipment on a basis which would result in the largest possible gain to the Partnership."

[43] See *Frank Lyon Co. v. Commissioner*, 435 U.S. 561, 583 (1978).

termination by Exxon and sale of the equipment by the Partnership—indicates to us not that tax consequences were the sole motivating force but that they quite appropriately were one factor considered at that stage of the transaction.

We conclude that the instant transaction clearly passes muster. Its economics were such that, while *tax savings* were expected to—and did—accrue to Partnership investors in the early years, at some point a "turn around" would be—and was—reached whereby depreciation and interest deductions would be less than income from the leases, and the investors would have to *pay taxes* on the Partnership profit. Consequently, the estimated net tax savings over the Partnership life—$14,324 for a 70-percent taxpayer[44]—were considerably less than the investor's $30,000 cash investment. From this we conclude that an investor in this Partnership could not have entered into this transaction solely for its tax benefits.[45] The potential for profit,[46] on the other hand, was substantial as we have found. We conclude, therefore, that this case is controlled by the result in *Frank Lyon*[47] and that the form of this transaction should be respected.

Both parties attempt to emphasize the significance of our recent opinion in *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184 (1983), affd. on this issue 752 F.2d 89 (4th Cir. 1985), which involved a computer purchase-and-leaseback arrangement[48] on the surface appearing to be similar to the leasing

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[44]See table, p. 418 *supra*.

[45]In our recent decision of *Estate of Baron v. Commissioner*, 83 T.C. 542 (1984), we noted, in the context of sec. 183, that a disparity between estimated before-tax profit and net tax benefits is a factor to be considered in the determination of profit objective. 83 T.C. at 558. Such an analysis, here, would further confirm the economic substance of the transaction.

[46]On the facts before us, profit is measured not against the full purchase price including the nonrecourse note, since payments on that note were in all events guaranteed by the lease or termination payments. Rather, it is measured against the investors' cash outlay. Cf. *Wildman v. Commissioner*, 78 T.C. 943, 954 (1982).

[47]We note that our opinion in *Hilton v. Commissioner*, 74 T.C. 305, 362–363 (1980), affd. per curiam 671 F.2d 316 (9th Cir. 1982), cert. denied 459 U.S. 907 (1982), found *Frank Lyon* to be distinguishable because of the following: (1) Rent during the initial lease term in *Hilton* was only sufficient to amortize 90 percent of the note principal, so that there was a substantial balloon at the end of the lease term; (2) the rent in *Hilton* was not based on fair rental value; (3) none of the investors' funds in *Hilton* went to the seller/lessee for purchase of the property; (4) the taxpayers, there, could not dispose of the property at a profit; (5) the contrived nature of the Partnership's formation and orchestration in *Hilton*. These distinctions lend further support for our view that the case before us is factually similar to *Frank Lyon* and thus should be controlled by its result rather than by the result in *Hilton*.

[48]Although the computer purchased in *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184 (1983), affd. on this issue 752 F.2d 89 (4th Cir. 1985), was an IBM System 370, none of the models at issue in this proceeding are of the same model as the one in *Rice's Toyota*. The testimony therein concerning residual value thus is of no relevance to this proceeding.

transaction at issue here. In analyzing the transaction, we indicated that the transaction either had to meet the subjective "business purpose" test, or it had to satisfy a more objective "economic substance" test indicating a "realistic opportunity for economic profit which would justify the form of the transaction." 81 T.C. at 202–203 & n. 17. We concluded that neither test had been met in that case and that the transaction was a sham. In affirming, the Court of Appeals recently confirmed the use of this test, noting in connection with the "economic substance" inquiry that the most credible estimates in the record indicated that residual value of the computer was not sufficient to earn a profit. The facts in the instant case are clearly distinguishable. We have found to the contrary that a profit was reasonably likely so that the economic substance test has been fairly met.

Respondent's reliance upon *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976), affg. 64 T.C. 752 (1975), and *Narver v. Commissioner*, 75 T.C. 53 (1980), affd. per curiam 670 F.2d 855 (9th Cir. 1982), likewise is misplaced. In both of those cases, the issue was whether nonrecourse debt was properly included in cost basis for the property involved in each case. We expressly found a lack of genuine indebtedness because the purchase prices of the properties were not shown to have equaled their fair market values. Under such circumstances, the Court of Appeals indicated in affirming our *Estate of Franklin* decision that the purported purchaser of the property had no incentive to pay off the nonrecourse note because by abandoning the transaction—and the property securing the debt—the taxpayer "can lose no more than a mere chance to acquire an equity in the future should the value of the acquired property increase." 544 F.2d at 1048.

This "prudent abandonment" test referred to by respondent has no place here where the parties have stipulated that the Partnership paid fair market value for the equipment.[49] Moreover, the Partnership clearly did not have an incentive to abandon the property when it had entered into leases virtually guaranteeing that monthly debt payments would be made,

[49]This is a characteristic of the transaction further distinguishing it from that in *Rice's Toyota World, Inc. v. Commissioner, supra*, where we found that the taxpayer paid more than fair market value for the equipment because he purchased only a 70-percent interest. 81 T.C. at 209. Even after 5 percent for brokers' fees is taken out, the Partnership owned 95 percent of residual value here.

either where the leases ran their full course or where they were terminated prematurely.[50]

Respondent's position is simply not supported by the record in this case. The transactions were genuine leases for all purposes including Federal income tax.[51] We hold for petitioners on this issue.[52]

Amortization of Hutton Fees

In view of our holding that the Partnership is the true owner of the equipment for tax purposes, we now must address the second issue: Whether the Partnership's payment to E.F. Hutton of $102,000 as a commission for obtaining offers to

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[50]We note that respondent attempts to demonstrate in charts appended to one of his briefs that, should the leases have been terminated prematurely by the lessees and the debts paid off by means of the termination payments, the Partnership would not have recouped its initial investment and started to build up equity until fairly close to the end of the lease terms. However, we conclude that these charts are unpersuasive in that: the residual values used therein are artificially low because they employ an "averaging of averages" of limited material in evidence; they ignore the fact that termination rights did not arise until well into the lease terms; and the leases clearly were not entered into by the Partnership in order to see them terminated prematurely, but were intended to run their full courses in the absence of some unforeseen circumstances. These charts do not, therefore, show an absence of equity such as was intended by *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976), affg. 64 T.C. 752 (1975), and its progeny, where the likelihood that the debt would be paid was the fundamental issue.

[51]At the Court's request, the parties have stipulated the extent to which the requirements of Rev. Proc. 75-21, 1975-1 C.B. 715, have been met. That revenue procedure established guidelines under which an advance ruling on a leveraged lease would be issued. All of the leases, here, satisfy all of the requirements of that revenue procedure, except for Guideline No. 1, which requires that the lessor must have a 20-percent minimum unconditional amount at risk in the property when the lease begins, throughout the entire lease term, and at the end of the lease term. Here, the equipment had sufficient useful life at all times to satisfy Guideline No. 1, and the Partnership had more than 10- but less than 20-percent equity in the equipment initially and during the term of the leases. Given these facts, we are further persuaded that respondent's position is unsound. The spirit of this "safe haven" revenue procedure—attempting to ascertain "true" ownership of the equipment—certainly has been met. The discrepancy between 10-plus-percent equity, here, and the 20 percent required by the guideline does not justify respondent's position.

[52]An issue not raised or briefed by the parties, but alluded to by some of the witnesses, is whether, in determining the economic viability of the instant transaction, we are required to discount the expected residual value of the equipment back to 1975 dollars. In the absence of statutory mandate, we decline to do so. While we are aware of our footnote 23 in *Hilton v. Commissioner*, 74 T.C. 305, 353 n. 23 (1980), affd. per curiam 671 F.2d 316 (9th Cir. 1982), cert. denied 459 U.S. 907 (1982), we note that the method employed therein was dictum in the context of circumstances bordering on the egregious.

Moreover, we do not feel competent, in the absence of legislative guidance, to require that a particular return must be expected before a "profit" is recognizable, the necessary conclusion to be drawn if we were to discount residual value. As stated in sec. 1.183-2(b)(9), Income Tax Regs., in a closely related context, "the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit." Our sole task here is to determine whether a profit was reasonably likely on these facts in order to find that tax avoidance was not the sole motivation for the transaction. Since the potential profit here was more than de minimis, we are satisfied that petitioners should prevail. See *Lemmen v. Commissioner*, 77 T.C. 1326, 1342-1347 & nn. 22 & 24 (1981).

purchase Partnership units was properly amortized over a 9-year period.

There appears to be no dispute between the parties that fees incurred by partnerships for syndication of their shares are nondeductible expenses which must be capitalized. *Blitzer v. United States*, 231 Ct. Cl. 236, 684 F.2d 874 (1982); *Derr v. Commissioner*, 77 T.C. 708, 733–734 (1981); *Kimmelman v. Commissioner*, 72 T.C. 294, 304–306 (1979). See 4A J. Mertens, Law of Federal Income Taxation, sec. 25.35, at 177 (1979 rev. & Supp. 1984). The question before us is what is the proper treatment of these capitalized costs. Petitioners contend that the Partnership should be permitted to deduct them in equal amounts annually over the Partnership's 9-year life. Respondent, on the other hand, asserts that amortization is inappropriate and that, while these costs must be capitalized, they may only be recovered upon liquidation of the Partnership. This Court has not yet decided whether amortization of syndication expenses is appropriate.

In the absence of precedent directly on point, we look to the rule in a closely analogous context. Fees paid by corporations in connection with stock issues (such as brokers' commissions) historically have been treated as a reduction of the capital received by the corporation upon issuance of its stock. *Surety Finance Co. of Tacoma v. Commissioner*, 77 F.2d 221 (9th Cir. 1935), affg. 27 B.T.A. 616 (1933); *Barbour Coal Co. v. Commissioner*, 74 F.2d 163 (10th Cir. 1934), cert. denied 295 U.S. 731 (1935); *Simmons Co. v. Commissioner*, 33 F.2d 75 (1st Cir. 1929), affg. 8 B.T.A. 631 (1927), cert. denied 280 U.S. 588 (1929). Accordingly, such expenses always have been held to be nonamortizable. The rationale for this rule was explained by the U.S. Court of Appeals for the Tenth Circuit, as follows:

> the function and scope of this [amortization] statute is to allow a deduction for the exhaustion of assets such as machinery, buildings, or other forms of personalty which depreciate through wear and tear. It has no application here because the expenditure in question was not to acquire property of that kind, but for capital in the form of cash for use in the business. It was not an exhaustible or depreciable asset. But it is said that the right to use the money thus acquired was a property right which is exhausted ratably with the passage of time and consequently an aliquot part of the expenditure made in acquiring it should be allowed as a deduction by way of exhaustion for each year during that period. The argument overlooks the controlling consideration that such a commission is a capital expenditure to be charged

against the proceeds of the stock, not recovered from operating earnings. It merely reduces the net returns from the sale of the stock and reduces the available capital. It has no relation to operating expenses. It is equivalent for income tax purposes to the sale of stock at a discount. There can be no substantial difference between the two. The discount in the one instance represents the difference between the par value of the stock and the amount received for it; the commission represents that difference in the other. A capital expenditure cannot be charged income. [*Barbour Coal Co. v. Commissioner, supra* at 164.]

In 1954, section 248 was enacted as part of the new Code, permitting corporations to elect to amortize organizational expenses over a period of 60 months or more. Pub. L. 83–591, 68A Stat. 76. However the legislative history of this section indicates that it is not applicable to fees paid by the corporation in connection with stock issues, in conformity with prior case law and generally accepted practice, since such fees were not considered to be of an amortizable character. H. Rept. 1337, 83d Cong., 2d Sess. 31, A64 (1954); S. Rept. 1622, 83d Cong., 2d Sess. 37, 224 (1954). See sec. 1.248–1(b)(3)(i), Income Tax Regs. We see no reason not to follow the rule applied in the corporate context, particularly in view of the close similarity between the types of expenses incurred by partnerships and corporations in the course of raising capital.[53] Accordingly, we hold that these Partnership syndication costs may not be amortized.

The propriety of our holding is confirmed by the fact that Congress as part of the Tax Reform Act of 1976 enacted new section 709 to the Code. Pub. L. 94–455, 90 Stat. 1547. Section 709(a), which was enacted after the instant syndication fees were incurred and paid, provides as follows:

SEC. 709(a). GENERAL RULE.—Except as provided in subsection (b), no deduction shall be allowed under this chapter[54] to the partnership or to any

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[53] An argument might be made that these expenses are similar to loan costs, which are capitalized and deducted pro rata over the life of the loan. *Detroit Consolidated Theatres, Inc. v. Commissioner*, 133 F.2d 200 (6th Cir. 1942), affg. per curiam a Memorandum Opinion of the Board of Tax Appeals; *Goodwin v. Commissioner*, 75 T.C. 424, 442 (1980), affd. without published opinion 691 F.2d 490 (3d Cir. 1982); *Cagle v. Commissioner*, 63 T.C. 86, 97 (1974), affd. 539 F.2d 409 (5th Cir. 1976). While this theory might be persuasive if we were writing on a clean slate, we cannot overlook the fact that the law in the corporate context—which clearly provides a closer analogy—is to the contrary.

[54] We note that the legislative history of this provision refers to deductions "under the partnership tax provisions (subchapter K of the code)," as contrasted with the broader language in the statute "under this chapter," which on its face encompasses amortization under sec. 167. S. Rept. 94–938, at 94, 1976–3 C.B. (Vol. 3) 132. See McGuire, "Can the Syndication Costs of a

partner for any amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) an interest in such partnership.

This new section was designed primarily to bring the treatment of "guaranteed payments" made to general partners for services rendered in connection with syndication and organization of limited partnerships in conformity with the treatment of similar expenses by corporations. S. Rept. 94–938, at 94, 1976–3 C.B. (Vol. 3) 132.[55] In codifying existing case law that such payments to partners were not deductible, the House report noted without comment the rule discussed above concerning the "netting" of stock issuing expenses. H. Rept. 94–658, at 121 n. 4, 1976–3 C.B. (Vol. 2) 813. There is no indication in the legislative history that Congress believed that it was changing the law or that partnership syndication fees had previously received different treatment from stock issuing expenses and been amortizable. Moreover, while it is not entirely clear whether the nondeductibility provision of section 709(a) is applicable to syndication fees incurred and paid during 1975[56] (such as those before us), nevertheless Congress has seen fit to preclude such deductions at least for all years thereafter. In view of Congress' clear awareness of prior case law both in the partnership and corporate contexts and its apparent intent generally to codify that law, we do not think that a different rule should be applied to the syndication fees before us.

We are aware that the Court of Claims recently held that a "front-end" administrative management fee which was in part "ancillary to the organization of the limited partnership and

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Partnership be Amortized? An Analysis of Authorities," 59 J. Tax. 208 n. 2 (1983). However, a reference to subch. K also necessarily includes those deductions flowed through to partners by reason of sec. 702(a)(7) (now sec. 702(a)(8))—such as depreciation and amortization. Thus this inconsistency is of no consequence here.

[55] Under sec. 709(b), a partnership may elect to amortize organization fees over a period of not less than 60 months in a manner similar to sec. 248, but—as was true of its corporate counterpart—this amortization provision was clearly not intended to be applied to syndication fees. S. Rept. 94–938, *supra* at 94, 1976–3 C.B. (Vol. 3) at 132.

[56] Sec. 709 (a) is applicable in the case of partnership taxable years beginning after Dec. 31, 1975. Consequently, on its face, this provision appears to be applicable to the years at issue here. However, the Conference report states:

"The conferees intend that no inferences should be drawn as to the deductibility (when paid) of partnership organization and syndication fees paid or incurred in taxable years beginning before January 1, 1976."

S. Rept. 94–1236, 94th Cong., 2d Sess. 421, 1976–3 C.B. (Vol. 3) 825. Because the conclusion we have reached is consistent with that required by the statute, we need not decide this question.

syndication of its shares" was not currently deductible but was "a capital expenditure to be amortized over the (50 year) life of the partnership." *Blitzer v. United States*, 231 Ct. Cl. 236, 684 F.2d 874, 893 (1982). However, we do not feel compelled to follow that ruling, despite our respect for the decisions of that court. Respondent conceded in *Blitzer* not only that capitalization of these fees was appropriate (as he does here), but also that, at most, amortization over the partnership's 50-year life was called for, a position argued by respondent here to be incorrect. Thus the Court of Claims did not have to address the amortization question in an adversarial context, nor did it approach the issue from a legal standpoint: It reached the conclusion argued for by respondent in the alternative.[57]

Accordingly, we conclude that respondent correctly determined that the Partnership could not amortize its syndication costs.

Decisions will be entered under Rule 155.

APPENDIX A

Below is a list of petitioners in this consolidated proceeding, along with their places of residence when their petitions were filed and the number of Partnership units owned by them.

Name	*Residence*	*Number of partnership units owned*
Imogene Thomas (individually and as personal representative of deceased husband, Jerry Thomas)	Jupiter, FL	1

[57]The new U.S. Claims Court more recently addressed the question of amortization of organization and syndication fees in the context of respondent's argument that *Blitzer* was wrongly decided. Stating that it had no authority to overrule *Blitzer*, that court simply held that amortization of syndication fees over the life of one of the partnership's office buildings ("a tangible asset with a useful life related to the syndication fee") was appropriate. *Sartin v. United States*, 5 Cl. Ct. 172, 179 (1984). Thus, there was no discussion concerning the legality of amortization in that opinion either.

Name	*Residence*	*Number of partnership units owned*
Robert P. Kuhn and Janice K. Kuhn	Cincinnati, OH	1/4
Henry F. Goller and Margaret K. Goller	Orchard Park, NY	1/2
Robert C. Baesel and Jeanne T. Baesel	Cincinnati, OH	1/4
Warren J. Welling and Alice M. Welling	Palm City, FL	1/4
George E. Schultz and Irene L. Schultz	Milford, OH	1/4
Roy B. Culler, Jr., and Dorothy P. Culler	High Point, NC	1
Neil C. Schauf	Santa Fe, NM	2
Marilyn M. Schauf	Stinson Beach, CA	- - -
James W. Powell and Annie J. Powell	Fort Lauderdale, FL	1
Elbert W. Phillips and Elizabeth C. Phillips	North Tonawanda, NY	1/2
William L. Albritton and Mary S. Albritton	Baton Rouge, LA	2
Raymond Leven and Nettie Leven	Maplewood, NJ	[1]2
Edward Waters and Jane C. Waters	Farmington, CT	1
Bayard C. Tullar and Teresa Tullar	Wellsville, NY	1

[1]The supplemental stipulation indicates that Raymond Leven, petitioner in docket No. 16415-82, owned one Partnership unit, but an examination of the Form K-1 prepared by the Partnership indicates that Mr. Leven owned two units. To the extent of this inconsistency, we will not follow the supplemental stipulation.

APPENDIX B

	1975[1]	*1976*	*1977*	*1978*	*1979*	*1980*	*1981*	*1982*	*1983*
Rental receipts	$118,188	$1,583,166	$1,598,158	$1,598,158	$1,598,158	$1,598,158	$1,598,158	$1,564,249	$942,062
Debt services	(46,745)	(1,464,788)	(1,515,304)	(1,515,304)	(1,515,304)	(1,515,304)	(1,515,304)	(1,481,130)	(802,602)
Projected cash to partnership	71,443	118,378	82,854	82,854	82,854	82,854	82,854	83,119	139,460
Projected partnership operating expenses[2]	(7,500)	(79,000)	79,000)	(79,000)	(79,000)	(79,000)	(79,000)	(78,000)	(60,000)
Projected cash to limited partners[3]	63,943	39,378	3,854	3,854	3,854	3,854	3,854	5,119	79,460

[1]1975 is not a year at issue.

[2]Includes fees paid to Alanthus in connection with the Exxon lease, fees paid to the general partner pursuant to the Partnership articles and legal and accounting fees paid to third parties in the course of administrating the leases and the Partnership.

[3]Due to higher than projected legal and accounting expenses, cash was actually distributed to the limited partners only in 1976 in the aggregate amount of $8,897.88. It was anticipated that a substantial portion of the 1975 and 1976 net cash-flow would be used to pay startup and acquisition expenses.

GULF OIL CORPORATION, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 22499–82. Filed March 18, 1985.

P and wholly owned subsidiary K executed an assignment agreement transferring certain of P's interests in five projects in the U.K. sector of the North Sea from P to K on Dec. 30, 1975, effective as of the close of business on Dec. 31, 1975, but "subject to any requisite consents and approvals being obtained thereafter." P and K were also to "use their best efforts to secure the approval of the Department of Energy and any other necessary approvals and consents in connection with the assignment." *Held*: Under English law, the assignment is not effective until the requisite consents and approvals have been obtained. "Requisite" includes both the consent of the Department of Energy and the approval of the Inland Revenue, neither of which was obtained before the end of the taxable year 1975. The assignment from P to K was not an effective transfer during the taxable year 1975.

J. Waddy Bullion, *Emily A. Parker*, *Sean T. Crimmins*, *Buford P. Berry*, *J.Y. Robb III*, and *Margaret S. Alford*, for the petitioner.

Raymond L. Collins and *William B. Lowrance*, for the respondent.

GOFFE, *Judge*: The Commissioner determined deficiencies in petitioner's Federal income tax for the taxable year 1974 in the amount of $80,813,428 and for the taxable year 1975 in the amount of $166,316,320. Petitioner and respondent, with the approval of the Court, agreed that only certain issues set forth in the statutory notice of deficiency, petition, and amended petition would be litigated at a special trial session commencing on July 30, 1984, at Dallas, Texas.

One of the issues to be litigated at this session was designated by the parties as the "North Sea Farmout" issue. This issue requires the resolution of three questions: (1) Whether there was an effective assignment in the taxable year 1975 by petitioner to Kupan International Co., by virtue of a document entitled "Kupan Assignment Agreement" entered into between petitioner and Kupan International Co., dated December 30, 1975, and effective at the close of business, December 31, 1975, of an undivided 50 percent of petitioner's

interest in agreements and letter agreements; (2) whether the assignment constituted a transfer under section 367, I.R.C. 1954, as amended, or, in the alternative, whether the assignment was a farm-out or farm-in;[1] and (3) the value of the items transferred. The resolution of the first question in favor of petitioner, i.e., that there was no assignment in the taxable year 1975, would obviate the need to resolve the remaining two questions, and avoid additional trial on this issue. By joint motion, granted on August 13, 1984, the Court has been asked to decide this preliminary question now, in the interest of judicial economy.

The issues for decision, therefore, are: (1) Was the Assignment Agreement a conditional contract; and (2) if the Assignment Agreement was a conditional contract, were the conditions satisfied, and the transfer, therefore, effective during the taxable year 1975.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and accompanying exhibits are so found and incorporated herein by reference.

Gulf Oil Corp. (hereinafter referred to as petitioner, Gulf, or GOC) is a corporation which was organized under the laws of the Commonwealth of Pennsylvania and which has its principal office at 439 Seventh Avenue, Pittsburgh, Pennsylvania. Gulf and certain of its subsidiary corporations, during the taxable years at issue, constituted an "affiliated group" as that term is defined in section 1504, I.R.C. 1954, as amended. Petitioner, directly and through its foreign subsidiaries and affiliates, is engaged on a world-wide basis in the exploration, development, production, purchase, and transportation of crude oil and natural gas and in the manufacture, transportation, and marketing of petroleum products.

Gulf, as the common parent of an affiliated group of corporations, timely filed consolidated Federal income tax

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[1] "Farm-out" is generally defined within the petroleum industry as an arrangement in which the owner of a working interest retains some part of the leasehold interest and assigns the remainder to another party who assumes part or all of the burden of development and operation. "Farm-in" is generally defined as an arrangement whereby the lessee "buys in" or acquires an interest in a lease or concession owned by the lessor on which oil or gas has been discovered or is being produced. Petroleum Industry Glossary 67-68 (1982).

returns for its taxable years 1974 and 1975 on behalf of itself, and certain of its subsidiary corporations, with the Office of the Internal Revenue Service at Pittsburgh, Pennsylvania.

An overriding fact affecting all transactions at issue in this case is that the laws of the United Kingdom (U.K.) have required that a license[2] to explore for and produce minerals in the U.K. sector of the North Sea be issued only to U.K. citizens resident in the U.K. or to U.K. corporate bodies.

Gulf decided to take its licenses in the U.K. sector of the North Sea in Gulf Oil (Great Britain) Ltd. (GOGB), which had been incorporated in the U.K. on March 1913. GOGB had been and is engaged in the marketing of crude oil products in the U.K. GOGB was a wholly owned subsidiary of Gulf through the taxable year 1975; thereafter, it was a wholly owned subsidiary of Transocean Gulf Oil Co., a wholly owned subsidiary of Gulf. Beginning on August 8, 1964, and as added to or amended in subsequent years, the U.K. Government awarded exploration and production licenses for the U.K. sector of the North Sea to GOGB.

Gulf Oil Production Co. (GOPCO) was incorporated in Delaware on July 16, 1964, as a wholly owned subsidiary of Gulf to conduct operations in the U.K. sector of the North Sea. By an agreement between GOGB and GOPCO dated September 17, 1964, and various supplemental agreements, GOGB transferred to GOPCO all of its interests in its licenses (including licenses which might thereafter be granted to or acquired by GOGB or in which GOGB might thereafter acquire an undivided ownership interest), except that GOGB retained a 12½-percent overriding royalty interest in each of the licensed areas. Subsequent to this agreement, GOGB remained the title holder of the licenses in question, but all activities with respect to the licensed areas were carried out by, and all costs were borne by, GOPCO.

GOPCO received a letter from L. Williams of the Department of Trade and Industry (the predecessor to the Department of Energy),[3] dated February 16, 1973, which stated:

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[2] "License" and "licence" are used interchangeably in the documents and stipulated exhibits. The American spelling of "license" is used throughout this opinion unless within a direct quotation.

[3] All references in this opinion to the Department of Energy, Inland Revenue, or Inland Revenue Oil Taxation Office refer to agencies, departments, or divisions of the U.K. Government, and not to any similarly named agency, department, or division of the U.S. Government.

ILLUSTRATIVE AND OTHER AGREEMENTS

As you know, offshore petroleum production licences provide that licensees may not assign or part with any licence rights or engage in sub-licensing without the written authority of the Secretary of State.

The Department places a wide interpretation on these provisions and wishes to have prior information about any proposals which could fall within their scope; for example, illustrative and similar agreements, overriding royalty agreements and various licence financing arrangements.

This letter is to give you notice accordingly. It will be in the interest of licensees to advise and consult the Department before entering into any transactions of this nature.

By a December 31, 1974, agreement between GOPCO and Gulf, GOPCO transferred all of its assets and liabilities to Gulf, including all of its North Sea interests acquired through its agreement with GOGB. After the transfer, Gulf assumed all activities and costs with respect to the North Sea interests. The transfer from GOPCO to Gulf was approved by the U.K. Department of Energy (also referred to hereinafter as DOE). By a letter dated December 5, 1975, from W.C. Gladstone of the Inland Revenue Oil Taxation Office to Donald H. North of Price Waterhouse & Co. (Price Waterhouse), Mr. Gladstone confirmed that the agreement between GOPCO and Gulf was approved and that Gulf would be regarded as a licensee within the meaning of section 12[4] of the Oil Taxation Act 1975.[5] Mr. Gladstone also confirmed that no capital gain implications arose from the transfer effected by the agreement.

Kupan International Co. (Kupan) was incorporated in Liberia in 1949. It had been an international finance company for several of Gulf's affiliates. Kupan was a wholly owned subsidiary of Gulf from its creation through the taxable year 1975; thereafter, it was a wholly owned subsidiary of Transocean Gulf Oil Co., a wholly owned subsidiary of Gulf.

In the fall of 1975, Kupan and Gulf began to work on a joint proposal by which a U.K. branch of Kupan would provide financing for some of Gulf's North Sea operations in exchange for a percentage interest in a portion of the property obtained by Gulf from GOPCO. The proposal evolved into the arrangement evidenced by the assignment agreement at issue in this

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[4] All section references, unless otherwise indicated, and all references to "Acts" are to the statutes of England.

[5] Oil Taxation Act 1975, ch. 22, sec. 12, at 1007.

case. Once the transaction was outlined, and a timetable established, formal offers and counteroffers were made.

By a letter dated November 12, 1975, Gulf offered Kupan 50 percent of Gulf's interests in five projects in the U.K sector of the North Sea: the Dunlin Unit, the Thistle Unit, the Statfjord Field, the 211/19 East Field, and the Brent Crude Oil Pipeline System. Kupan, in turn, would assume 75 percent of Gulf's development expenditure obligations in connection with the five projects. The proposal was made subject to obtaining any necessary approvals from the U.K. Government and other interested parties. By letter dated November 20, 1975, Kupan made a counterproposal to Gulf which did not include the 211/19 East Field, and under which Kupan would issue 65 percent of Gulf's development expenditure obligations rather than 75 percent as initially proposed by Gulf. Kupan's counterproposal was also made subject to obtaining the necessary approvals from the U.K. Government.

Gulf accepted the counterproposal by letter dated December 2, 1975, and arranged for preparation of the assignment agreement and operating agreement, with the restriction that the final agreement would be subject to Department of Energy and other consents to be listed in the agreements. On December 30, 1975, Gulf and Kupan executed two agreements. One was entitled "Kupan Assignment Agreement" (Assignment Agreement), the other "Operating Agreement."

Relevant clauses of the Assignment Agreement provide as follows:

[Clause 1:]

* * * * * * *

As of and with effect from the close of business on the thirty first day of December, 1975 (hereinafter called "the effective date") *subject only to any requisite consents and approvals being obtained thereafter*, GULF shall and does hereby assign and transfer to KUPAN and KUPAN shall and does hereby accept the assignment and transfer by GULF of,

* * * * * * *

[Clause 2(b):]

To the knowledge of GULF no notice of default, withdrawal, or revocation has been received by any of the parties to said agreements. GULF hereby undertakes to perform all obligations on its part to be performed under said

agreements from the date hereof *pending coming into force of this agreement.*

[Clause 3:]

GULF and KUPAN will use their best efforts to secure the *approval of the Department of Energy and any other necessary approvals and consents in connection with the assignment of GULF's interests.* If the approval of the Department of Energy and other necessary approvals and consents to the aforesaid assignment are not obtained by June 30th 1976 or such other date as the parties may mutually agree, this Agreement and the said Operating Agreement shall automatically determine on a date to be agreed between the parties * * *

[Clause 10:]

This agreement shall be governed by and construed in accordance with the laws of England.

[Emphasis added.]

The initial premise was that the transaction, if appropriately structured, should have no U.K. tax consequences, positive or negative. Memoranda, notes, telexes, and letters by employees and attorneys of Gulf and employees of Price Waterhouse evidence, however, a continuing requirement that Inland Revenue approve the transaction to avoid any capital gain taxes under section 38(5) of the Finance Act of 1973,[6] obtain relief from petroleum revenue taxes under the Oil Taxation Act 1975, and avoid any other adverse tax consequences. Meetings and conversations were held with Inland Revenue employees throughout the negotiations, and continued after the execution of the Assignment Agreement. It became apparent that the transaction would require three levels of negotiation with the U.K. Government: (1) Participation agreements between the North Sea oil field licensees and the U.K. Government would have to be resolved; after which (2) the Department of Energy would give its approval to the transaction; after which (3) Inland Revenue would give its clearance as to adverse tax consequences.

Potential problems with Inland Revenue were apparent before the execution of the Assignment Agreement. The tax authorities expressed concern about the administrative burden caused by fragmentation in the oil fields, and potential avoidance of petroleum revenue tax under the Oil Taxation Act 1975. More importantly, the tax authorities also declared that capital gains tax would result from the transaction, as

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[6] Finance Act 1973, ch. 51, sec. 38, at 1464–1466.

structured, under section 38(5) of the Finance Act 1973. The participation agreements that were to be concluded before the Department of Energy could give its consent were also moving more slowly than expected. By mid-January 1976, Gulf began to develop an alternative arrangement by which Kupan would release its rights under the Assignment Agreement to Silvertown Lubricants Ltd. (also referred to as Gulf (U.K.) Offshore Investments Ltd.), which was to become a U.K. subsidiary of Kupan. These changes and others were intended to increase the probability that the necessary consents and approvals could be obtained. Portions of the documents[7] relevant to this opinion, between October 1975, and March 1976, are:

A. Letter from D.H. North, Price Waterhouse, dated October 24, 1975, to B.R. Edwards of Gulf:

> Turning now to the farm-in/farm-out arrangements between GOC and Kupan, when matters have reached the stage of a draft agreement between those two companies then I think it is most desirable for the draft agreement to be submitted to the UK Revenue authorities for confirmation on the following points:
>
> 1. That no charge to UK capital gains tax will arise as the result of the disposal by GOC of part of its interests in the North Sea fields to Kupan, or on the change in the income sharing ratio.
>
> 2. That both Kupan and GOC will obtain tax relief for the capital expenditure which they will be incurring. In this respect I am assuming that Kupan will not take over any of the expenditure already being incurred by GOC but problems can arise in the event of the share of the income from the fields being different from the proportion in which expenditure on the fields is being incurred and this is a matter which requires clearance from the UK Revenue authorities.
>
> 3. That no problems will arise in respect of PRT [petroleum revenue tax under the Oil Taxation Act 1975] and that both GOC and Kupan will in principle be able to claim PRT relief (with uplift where appropriate) for the expenditure which they are incurring.

B. Memorandum from J.C. Wilcox, Law Department of Gulf, dated October 27, 1975, to J.W. O'Toole, Tax Department of Gulf, London:

> Regarding consents to and notifications of the proposed assignment:—
>
> 1. A simple notification to the Government as was done in the case of the assignment from GOPCO to GOC is all that should be necessary in this case. The GOPCO interest was acquired under the "pass through" agreement of 17th September, 1964 with GOGB and no *written* Government consent was

[7]Excerpts from all documents have been reproduced literally, with the exception of material appearing in brackets and the addition of emphasis.

obtained for the acquisition. However, if the proposed assignment should take place subsequent to passage of the Petroleum and Submarine Pipelines Bill, the consent of the Minister would be necessary. [Emphasis added.]

This memorandum further notes that the unitisation letter agreements and other contracts and agreements relating to the North Sea oil fields might require consents to the proposed assignment, although the majority of the agreements and contracts required only that notice be given.

C. Notes by D.H. North of Price Waterhouse about a meeting held at Gulf House in London on October 31, 1975; attending: J.W. O'Toole, L.F. White, and B.R. Edwards of Gulf; D.H. North and K.J. Howes of Price Waterhouse:

they were not expecting any UK tax advantage, although they hoped that there would be no disadvantage either. It is essential that these arrangements be effected by 31 December 1975. The broad outline of the arrangements is that Kupan will in future provide 65% of the capital in return for 50% of the income. The reason for the discrepancy is that GOC has incurred the expenditure to date, from which Kupan will benefit, and therefore the latter should take account of the earlier expenditure. * * *

It was agreed that in view of the urgency the matter should be broached with the Revenue at the meeting already arranged for 4 November * * *

D. Notes by D.H. North of Price Waterhouse about a meeting held at Somerset House on November 4, 1975; attending: W.C. Gladstone, N. Hermsen, and M.F. Bickerton of Inland Revenue; D.H. North and K.J. Howes of Price Waterhouse; L.F. White of Gulf:

The question of the Kupan farm in/farm out was then raised, and the Revenue were asked whether they would regard Kupan as a licensee and whether relief for capital expenditure would be available in the proportions in which the expenditure was incurred. DHN [D.H. North] suggested that this was inter-group farm in/farm out, and suggested Schedule 3, paragraph 5 might cover the situation, so that Kupan would stand in the shoes of GOC. The Revenue wished to give the position further consideration and it was suggested that we should send them the draft agreement when it was at a fairly final stage, and then let them know of any subsequent amendments. *They would not clear the position until the Department of Energy had given approval.* [Emphasis added.]

E. Notes by D.H. North about a meeting held at Melbourne House on December 17, 1975; attending: W.C. Gladstone and N. Hermsen from Inland Revenue Oil Taxation Office; L.F.

White and J.J. Fluken from Gulf; D.H. North and K.J. Howes from Price Waterhouse:

Mr Gladstone raised the question of the proposed Kupan farm in, and stated that the Revenue would have to be satisfied that there were very sound commercial reasons for the proposal. They were not generally happy with this sort of agreement, and were concerned at the extent of fragmentation. * * * The first step is to obtain D of E [Department of Energy] agreement, but no application has yet been put in.

Mr Gladstone stated that the Revenue were not certain that there were no capital gains tax implications. These were proved fields, and this was not an arms length transaction. DHN said that he hoped that as no cash was passing the Revenue would accept that there was no capital gain. However the Revenue thought that there could be a problem.

* * * * * * *

The Revenue will look further into the capital gains position and also as to whether this is a kind of agreement which they could approve, and will let us know. A draft agreement is to be supplied.

F. Notes by D.H. North of Price Waterhouse with reference to a telephone conversation on December 18, 1975, with N. Hermsen of Inland Revenue:

I telephoned Mr Hermsen to seek clarification as to why the Revenue authorities thought it likely that there would be charge to capital gains tax on the proposed GOC/Kupan farm-in/farm-out arrangement.

* * * * * * *

In the case in the proposed GOC/Kupan arrangements these related to proven fields and Mr Hermsen said that it was the first instance of a farm-in/farm-out arrangement for a proven field. * * * [T]he Revenue authorities thought the consideration received whether in cash or otherwise would be greater than the expenditure originally incurred so that a capital gains tax liability would arise. * * *

Mr Hermsen said that both he and Mr Gladstone are going to give further consideration to the matter in conjunction with Mr Davies.

G. File memorandum by J.W. O'Toole of Gulf with reference to a telephone conversation on December 22, 1975, with D.H. North of Price Waterhouse:

I pointed out to North that no progress is likely to be made with either the DOE or the Revenue on the Kupan farm-in until the Participation agreement has been reached with the DOE. After that occurs we will utilize the goodwill and the commitments in the Participation agreement to achieve both DOE and Inland Revenue approvals of the Kupan farm-in.

H. Notes by D.H. North of Price Waterhouse with reference to a telephone conversation on December 31, 1975, with L.F. White of Gulf:

I telephoned Len White concerning the proposed Kupan farm-in/farm-out arrangement with GOC * * *. Len White indicated that they had not yet received, or indeed asked for, DOE consent to the proposed arrangements yet since they were still revising the participation arrangements in various fields. It was hoped that these participation arrangements would be completed today following which they would be going to the DOE on the proposed Kupan farm-in. Len White agreed with me that the Oil Taxation Office had indicated that there was no purpose sending the Kupan agreement to them until DOE consent to the arrangements had been obtained and in these circumstances there is no question of anything being sent off this week.

I. File memorandum by D.H. North of Price Waterhouse with reference to a telephone conversation of January 14, 1976, with W.C. Gladstone of Inland Revenue:

I then mentioned to Mr Gladstone that Gulf were considering having the transfer to a UK subsidiary of Kupan's, so that Section 38(5) could be applied, and Mr Gladstone is to give further thought as to whether they could accept this situation, perhaps if the income expenditure and rights were all brought into line. He suggested that we might sound out the Department of Energy, as this was really a joint approval.

J. Aide memoire by B.R. Edwards dated February 4, 1976 (referring to the new proposal by which Kupan would assign its rights in the Assignment Agreement to Kupan's U.K. subsidiary):

The purpose of this aide memoire is to describe the subject farm out and the approvals of it to be requested from the Secretary of State under the Petroleum and Submarine Pipelines Act of 1975 and the Inland Revenue under the Oil Taxation Act 1975.

* * * * * * *

The farm out is effective only after the necessary government approvals and clearances been granted, i.e.:

(a) Approval by the Secretary of State for Energy under the Petroleum and Submarine Pipelines Act 1975,

(b) Approval by the Board of Inland Revenue and certification by the Secretary of State for Energy under the Oil Taxation Act 1975 and

(c) Clearance that capital gains will not arise; Revenue concurrence to the applicability of Section 38(5) of the Finance Act 1973 is being requested.

K. Notes by D.H. North of Price Waterhouse about a meeting at Gulf House on February 6, 1976; attendees: J.W. O'Toole, L.F. White, and B.R. Edwards of Gulf; K.J. Howes and D.H. North of Price Waterhouse:

it was thought that the best way of tackling the problem was to treat the 30 December 1975 agreement as being a conditional one, the conditions of which have never been satisfied, so that for UK CGT [capital gains tax] there was no disposal. The new agreement between GOC and Kupan UK would then transfer to the latter the rights which Kupan would have had under this 30 December 1975 agreement, and for UK CGT purposes it is irrelevant whether this is a disposal at 30 December 1975 or in February 1976, as it should be protected by Section 38(5) in either case.

L. Letter dated February 13, 1976, from D.H. North of Price Waterhouse to N. Hermsen of Inland Revenue Oil Taxation Office:

I refer to our recent telephone conversation * * *. Since these agreements were conditional on obtaining the requisite consents and approvals and these consents and approvals have not been obtained, the agreements have never come into effect and we are now enclosing a copy of a draft agreement to be entered into between Gulf Oil Corporation, Silvertown Lubricants Ltd and Kupan International Company whereby Silvertown assumes the rights and obligations which Kupan would have had under the agreements had they become effective.

M. Telex dated February 23, 1976, from B.R. Edwards of Gulf to H.C. Vivian of Kupan:

THE ORIGINAL PROPOSAL, AS EMBODIED IN THE DECEMBER 30 ASSIGNMENT AND OPERATING AGREEMENTS, WAS FOR KUPAN TO HAVE A BRANCH OPERATION IN THE U.K. stop THIS WAS MODIFIED EARLY IN JANUARY AS PRELIMINARY CONTACTS WITH THE U.K. INLAND REVENUE INDICATED SOME RESISTANCE TO THE BRANCH CONCEPT AND TO GIVING CAPITAL GAINS CLEARANCE IN THE CASE OF A BRANCH stop IT WAS, THEREFORE, DECIDED TO USE A U.K. INCORPORATED COMPANY AS THE KUPAN VEHICLE stop THIS WOULD HAVE NO ADVERSE U.S. TAX CONSEQUENCES, AS COMPARED WITH A BRANCH OPERATION stop IT WAS THOUGH PREFERABLE THAT THIS COMPANY SHOULD HAVE EXISTED ON DECEMBER 30, 1975, AND BEEN A MEMBER OF THE GULF GROUP stop A DORMANT SUBSIDIARY OF GULF OIL (GREAT BRITAIN) LTD., CALLED SILVERTOWN LUBRICANTS LTD., WAS, THEREFORE, SELECTED TO BE THE KUPAN VEHICLE stop

THE TRANSFER OF SILVERTOWN LUBRICANTS LTD. FROM GULF OIL (GREAT BRITAIN) LTD. TO KUPAN SHOULD BE COMPLETED NEXT WEEK stop * * *

WE ARE GOING AHEAD TO OBTAIN THE REQUIRED CONSENTS FOR THE FARMIN FROM THE U.K. GOVERNMENT stop THE DEPARTMENT OF ENERGY WERE INFORMALLY TOLD OF OUR INTENTIONS ON FEBRUARY 4 AND AN AIDE MEMOIRE PRESENTED TO THEM stop THEIR FORMAL CONSENT WILL BE OBTAINED AFTER

PARTICIPATION TERMS ARE SIGNED stop WE HAVE SENT THE INLAND REVENUE THE ENCLOSED DRAFT AGREEMENT AND AN AIDE MEMOIRE * * * stop WE PLAN TO MEET AND DISCUSS THE MATTER WITH THEM, PROBABLY LATE THIS MONTH OR EARLY MARCH stop THEY HAVE ALREADY INDICATED THAT THEY WILL NOT GIVE THEIR FORMAL APPROVAL AS REQUIRED UNDER THE OIL TAXATION ACT 1975, AND THEIR CAPITAL GAINS CLEARANCES, UNTIL WE HAVE OBTAINED THE APPROVAL OF THE DEPARTMENT OF ENERGY stop

N. Notes by D.H. North of Price Waterhouse and B.R. Edwards of Gulf about a meeting on February 26, 1976, at Oil Taxation Office; attendees: O.P. Davies and N. Hermsen of Inland Revenue Oil Taxation office; L.F. White and B.R. Edwards of Gulf; D.H. North and K.J. Howes of Price Waterhouse:

Davies agreed that the 30 December 1975 agreement could be ignored as a nullity, as it had never come into effect.

* * * * * * *

Mr White enquired whether it was accepted that Section 38(5) covered Silvertown and whether it was confirmed that the 30 December [1975] agreement was a nullity. Davies thought it must be a nullity because approval was not given and was not now being sought.

The Revenue accepted that the December 30, 1975 agreement between the GOC and Kupan was a nullity, and that the GOC/Silvertown transfer was covered by S. 38(5)F.A. [Finance Act] 1973. No capital gains therefore arose. The remark was made by them that *if the Revenue approved the GOC/Silvertown farm out it would be the first occasion on which they had approved fragmentation.* [Emphasis added.]

O. Implementation schedule dated March 3, 1976, for new arrangement using Silvertown Lubricants Ltd.:

The Participation agreement between Gulf/Conoco and H.M. Government was signed on February 26, leaving the way clear to formally apply for Department of Energy approval to farm in.

The schedule includes formal Department of Energy approval, as well as Inland Revenue clearances and approvals.

By agreements dated December 29, 1976, and December 31, 1976, the interests that were the subject of the Assignment Agreement were assigned, "subject to all necessary and requisite consents and approvals," from GOGB to Silvertown Lubricants Ltd./Gulf (U.K.) Offshore Investments Ltd., which was, by then, a wholly owned U.K. subsidiary of Kupan. The

issue of whether this assignment was conditional and/or effective during the taxable year 1976 is not before this Court.

On July 1, 1982, the Commissioner timely issued a statutory notice of deficiency to petitioner, determining deficiencies in the amounts of $80,813,428 for the taxable year 1974, and $166,316,320 for the taxable year 1975. As relevant to this opinion, the Commissioner determined that the Assignment Agreement dated December 30, 1975, was a taxable event under section 367, I.R.C. 1954, as amended, resulting in ordinary income to petitioner for the taxable year 1975 in the amount of $29,652,506.

Petitioner timely filed a petition with this Court requesting a redetermination of the deficiencies as set forth in the statutory notice of deficiency, and further disputing the determination based upon claims for overpayment of tax.

OPINION

The issues for decision are: (1) Whether the Assignment Agreement was a conditional contract; and (2) if the Assignment Agreement was a conditional contract, whether the conditions were satisfied, and the transfer, therefore, effective during the taxable year 1975. A transfer within the taxable year 1975 is a necessary prerequisite for the application of section 367, I.R.C. 1954, as amended, in this case. The existence of such a transfer depends upon the effect of the Assignment Agreement. Both petitioner and respondent offered expert testimony on the construction and application of contracts under the laws of the United Kingdom, and, to a large degree, the testimony of the expert witnesses on such law coincide.

The Commissioner's determinations in his statutory notice of deficiency are presumptively correct, and petitioner has the burden of disproving each individual adjustment. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a), Tax Court Rules of Practice and Procedure. Petitioner, therefore, bears the burden of proving that there was no transfer from petitioner to Kupan under the Assignment Agreement in the taxable year 1975.

The initial premise applicable to all contracts under U.K. law is that the court must look no further than the four corners of the document to determine its validity and construc-

tion. For purposes of the construction of the contract, therefore, we look only to the Assignment Agreement, and disregard the facts set forth above concerning the intentions or wishes of the parties.

Contracts are valid either in law or in equity. For an assignment to be effective in law, the contract must comply with section 136 of the Law of Property Act 1925,[8] which requires an absolute assignment. For an assignment to be absolute, the contract must be unconditional on its face. *Durham Bros. v. Robertson*, (1898) 1 Q.B. 765, 772. If there is a condition that must be satisfied before the contract becomes absolute, the contract is too vague, not enforceable by specific performance, and not valid by law. *Tailby v. Official Receiver*, (1888) 13 App. Cas. 523, 534, 547.

In this instance, the language of clause 1, "subject only to any requisite consents and approvals being obtained thereafter," and clause 3, "GULF and KUPAN will use their best efforts to secure the approval of the Department of Energy and any other necessary approvals and consents in connection with the assignment of GULF's interests," is clearly conditional on its face, assuming requisite consents and approvals existed at that time, and we agree with both expert witnessess that the Assignment Agreement, by its terms, is not an effective assignment in law.

A contract may be effective in equity, even though conditional on its face, upon the satisfaction of the contractual conditions. Lord Fry, in *In re Casey's Patents. Stewart v. Casey*, (1891) 1 Ch. 104, 118, explains the contrast between an unconditional and conditional assignment:

> The distinction I take to be this: That an agreement which does not exhibit the intention of the parties that the property shall pass at once does not take effect as an equitable assignment at once, but only when, from the terms of the agreement, it can be gathered that the intention of the parties is that the equitable property shall pass. On the other hand, where the intention is that the property shall pass either at once or upon the satisfaction of some condition, then the equitable property does pass at once or upon satisfaction of that condition, as the case may be.

[8] Law of Property Act 1925, 15 Geo. 5, ch. 20, sec. 136, at 663.

We must, therefore, further examine the contract in order to determine the nature of the conditions which must be satisfied in order for the assignment to be effective.

Respondent asserts that the only "necessary" or "requisite" consents and approvals are those required to make the assignment effective. Respondent argues that Department of Energy approval, even though specifically enumerated in clause 3, was not in fact required because no such approval was required by statute to make the assignment effective. As approval or consent by the U.K. tax authorities is also not a requisite under the contract for the assignment to become effective, respondent further contends that such approval or consent is neither requisite nor necessary. Respondent argues that this position is buttressed by petitioner's inability to specify either the statutory provisions under which the Department of Energy consent is "necessary," under this interpretation of the word, or any other consent or approval "necessary" or "requisite" for the completion of the assignment under the English law of contracts. Respondent also asserts that petitioner never sought any consents or approvals from the Department of Energy or anyone else. The conclusion drawn from these arguments is that no approvals or consents were in fact requisite or necessary and that the apparent conditional language was of no effect and that the assignment was effective in the taxable year 1975.

Petitioner argues that the conditional language cannot be read in the narrow sense of only requiring those consents and approvals necessary to make the assignment effective, but that the conditions include those consents and approvals necessary to meet the commercial needs of the parties. Petitioner initially contends that the consent of the Department of Energy was necessary under section 12 of the Oil Taxation Act 1975. Petitioner also asserts, however, that the Department of Energy consent was required by the parties as a precondition to Inland Revenue approval, even if not required by statute. Petitioner further argues that the Department of Energy consent was only one of the requisite consents and approvals, and that approval by the taxing authorities was also necessary if the transaction was to have the purpose and effect intended by the parties.

We find petitioner's arguments persuasive. The pertinent language of clauses 1, 2, and 3 is:

Clause 1: "* * * subject only to any requisite consents and approvals being obtained thereafter."

Clause 2(b): "* * * pending coming into force of this agreement."

Clause 3: "GULF and KUPAN will use their best efforts to secure the approval of the Department of Energy and any other necessary approvals and consents in connection with the assignment of GULF's interests."

Respondent would read "requisite" in clause 1 and "necessary" in clause 3 to mean only "necessary to effectuate the assignment" without regard to the commercial context of the transaction. This argument is valid only if the words "requisite" and "necessary" are interpreted according to the most narrow dictionary meanings, and if the contract is viewed in a vacuum, separated from the reality that tax and regulatory consequences are always important in any major commercial transaction. Lord Wilberforce, in the often-cited case *Prenn v. Simmonds*, (1971) 1 W.L.R. 1381, 1383–1384, stated that, in order to understand an agreement:

> it must be placed in its context. The time has long passed when agreements, even those under seal, were isolated from the matrix of facts in which they were set and interpreted purely on internal linguistic considerations. * * * We must * * * inquire beyond the language and see what the circumstances were with reference to which the words were used, and the object, appearing from those circumstances, which the person using them had in view. * * *
>
> * * * * * * *
>
> Surrounding circumstances may, * * * "stamp upon a contract a popular or looser meaning" than the strict legal meaning, certainly when to follow the latter would make the transaction futile. "It is easier to give a new shade of meaning to a word than to give no meaning to the whole transaction." [Quoting Justice Cardozo in *Utica City National Bank v. Gunn*, 118 N.E. 607 (1918).]

The stipulated exhibits, which were not objected to as irrelevant at the time of trial, show that both Department of Energy consent and the approval of Inland Revenue were in fact considered to be both necessary and requisite to effect the purpose of the transaction. Tax clearances and the prerequisite approval by the Department of Energy were not

merely "convenient," as asserted by respondent, but critical if the contract were not to be futile.

> if it can be shown that one interpretation completely frustrates that object, to the extent of rendering the contract futile, that may be a strong argument for an alternative interpretation, if that can reasonably be found. But beyond that it may be difficult to go: it may be a matter of degree, or of judgment, how far one interpretation, or another, gives effect to a common intention * * * [*Prenn v. Simmonds*, *supra* at 1385.]

To find that the "necessary" or "requisite" consents and approvals could include consent by the Department of Energy and approval by the Inland Revenue, is to accomplish the purpose of the contract, while to find that the assignment was immediately effective would totally contradict the common intention of the parties that the assignment be conditioned upon the requisite consents and approvals.

We must, therefore, apply the contractual clauses as constructed, conditioning the assignment upon "necessary" or "requisite" consents and approvals, to determine whether any such consents and approvals existed, and if they were obtained during the taxable year 1975. The consent of the Department of Energy is specified in the contract. Petitioner's initial argument is that such approval was, in fact, required by the Oil Taxation Act 1975.

The Oil Taxation Act 1975 came into force upon receiving the Royal Assent on May 8, 1975. The act imposed a new tax, called the petroleum revenue tax, upon the profits from oil and natural gas extracted under U.K. license, and contains a complex scheme for the determination of the expenditures which may be deducted to determine profits. The act permits an "uplift" of 75 percent on the actual capital expenditures on the field, a matter of particular concern to petitioner and Kupan. Section 12 of the Oil Taxation Act 1975 defines a "licensee" for purposes of the Act as follows:

> (*a*) the person entitled to the benefit of a licence or, where two or more persons are entitled to the benefit of a licence, each of those persons; and
> (*b*) a person who has rights under an agreement which is approved by the Board [defined in section 21(2) as the Commissioners of Inland Revenue] and is certified by the Secretary of State to confer on that person rights which are the same as, or similar to, those conferred by a licence;

Both petitioner and Inland Revenue consistently operated on the assumption that petitioner's assignment to Kupan was the type of agreement which required prior approval under section 12 of the Oil Taxation Act of 1975. Gulf had, in fact, already been notified by Inland Revenue that it was considered to be a licensee within the terms of section 12, and that Inland Revenue, therefore, mandated the Department of Energy consent before tax clearance would be given. Furthermore, the broad oversight policy set forth in the Williams letter (*supra* pp. 449–450 of this opinion) appeared to require review and approval, even if not statutorily required, or mandated by Inland Revenue.

Respondent cites the Wilcox memorandum of October 27, 1975 (*supra* pp. 453–454 of this opinion), for the proposition that petitioner thought that no consents were necessary. He further asserts that petitioner did not seek the consent or approval of the Department of Energy or of anyone else. The Wilcox memorandum is merely one document of many, and is from one of petitioner's non-tax attorneys to an attorney in the tax department. Its context makes clear that the notifications referred to were primarily of a purely contractual nature, and not related to tax clearances, consents, and approvals. The second assertion is contradicted by the record showing countless meetings with Inland Revenue and numerous contacts with the Department of Energy with respect to the preliminary participation agreements. The argument also disregards the fact that Department of Energy and Inland Revenue approval were both sought and obtained for the transfer from GOPCO to Gulf.

Respondent places some reliance on the fact the Petroleum and Submarine Pipelines Act 1975, although placing a new consent requirement upon such contracts, did not apply retroactively to this type of agreement, if executed before January 1, 1976. Petitioner does not disagree, and sought consent from the Department of Energy under that statute only when it appeared that the new agreement would be included within the ambit of the Petroleum and Submarine Pipelines Act 1975, as well as the Oil Taxation Act 1975. It is apparent, however, that the consent of the Department of Energy was mandatory under section 12 of the Oil Taxation Act 1975, as discussed above; that it was advisable under-

standing Government policy as reflected by the Williams letter (*supra* pp. 449–450 of this opinion); and that it was also required by the Inland Revenue before it would give tax approval.

Further, approval of the agreement by the Department of Energy was not the only "requisite" consent or approval that had to be obtained before the assignment would be effective. Inland Revenue was consulted regularly by both petitioner's employees and petitioner's representatives at Price Waterhouse about the numerous tax matters to be resolved. Respondent contends that Kupan would have had no interest in the tax consequences to petitioner, and that Kupan would interpret the language of clauses 1 and 3 to mean only those conditions that would effectuate the assignment. This contention disregards the "matrix of facts" set forth by Lord Wilberforce in *Prenn v. Simmonds, supra*, including the inception of the arrangement, and the very purpose and aim of the transaction. It also disregards the fact that at least some of the potential adverse tax consequences would have fallen upon Kupan.

A final argument by respondent is that petitioner itself treated the assignment as effective until it became apparent that the assignment as originally structured would have adverse tax consequences. The record is clear that the potential difficulties with Inland Revenue were known before the execution of the Assignment Agreement, and that the assignment was treated as ineffective pending resolution of the controversy. The language in D.H. North's notes of the meeting on February 6, 1976 (*supra* p. 457 of this opinion), that "it was thought that the best way of tackling the problem was to treat the * * * agreement as being a conditional one," is more indicative of a characterization of the reason why the assignment was ineffective than an attempt to avoid a completed assignment. The parties to the agreement did treat the agreement to assign as effective throughout, but also consistently treated the assignment itself as conditional.

The major items for consent and approval which were conditions precedent to an effective assignment, and which petitioner continued to attempt to resolve after the end of the taxable year 1975, were:

(1) When and if the participation agreements between the oil companies with interests in the North Sea oil fields and the U.K. Government would be resolved;

(2) Whether the Department of Energy would provide approval under its general oversight policy, and certification under the Oil Taxation Act 1975;

(3) Whether capital gains tax would be imposed by the Inland Revenue under section 38(5) of the Finance Act 1973;

(4) Whether Kupan and Gulf would be able to obtain tax relief for the capital expenditures incurred under the Oil Taxation Act 1975;

(5) Whether Inland Revenue might not approve of the transaction for non-tax reasons, i.e., its concerns about fragmentation or the commercial basis for the transaction; and

(6) Whether the necessary consents to the proposed assignment could be obtained under the contractual agreements governing various operations of the North Sea oil field.

It is not necessary for us to resolve when, if ever, all of the necessary consents and approvals were obtained for the assignment, as restructured in the taxable year 1976. We hold merely that the assignment under the Assignment Agreement was subject to numerous conditions, and that the conditions were not satisfied during the taxable year 1975. The Assignment Agreement did not, therefore, effect a transfer of any interests from Gulf to Kupan in the taxable year 1975.

We again note that this opinion resolves this one issue only, and that all other issues in this docket are still before the Court.

We decide this issue for petitioner.

CRAIGIE, INC., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 21240-80. Filed March 19, 1985.

For the taxable years 1971 through July 24, 1975, petitioner was a member of an affiliated group of corporations filing consolidated returns. On the consolidated return for 1973, Fidelity, the common parent, claimed a deduction of $22,172,534 for an investment loss. On examination of the return, respon-

dent disallowed the claimed loss as a deduction for 1973 and issued a notice of deficiency. By signing a statutory notice statement-waiver (Form 4089) on Mar. 26, 1980, Fidelity agreed that the loss was not deductible for 1973. Petitioner did not sign or agree to the execution of the waiver.

For taxable periods beginning July 24, 1975, the date on which it ceased to be a member of the affiliated group, petitioner filed separate returns. For 1975 and 1976, petitioner claimed deductions for net operating loss carryovers from 1973 based on the $22,172,534 loss shown on the consolidated return for that year. Respondent disallowed the carryover deductions on the ground that Fidelity was the sole agent of each subsidiary in the group with respect to the 1973 consolidated return and, as such, was duly authorized to agree to the disallowance of the loss for that year with the result that petitioner is not entitled to the claimed carryover deductions for 1975 and 1976.

Held: under sec. 1.1502–77(a), Income Tax Regs., Fidelity had authority to agree that the disputed investment loss is not allowable for 1973; petitioner's motion for partial summary judgment will be denied.

Frank W. Hardy, for the petitioner.
William L. Ringuette, for the respondent.

FEATHERSTON, *Judge*: This case was assigned to Special Trial Judge Hu S. Vandervort pursuant to section 7456[1] and Rules 180 and 181. The Court agrees with and adopts his opinion which is set forth below.

OPINION OF THE SPECIAL TRIAL JUDGE

VANDERVORT, *Special Trial Judge*: This case is before the Court on petitioner's motion for partial summary judgment, filed on February 24, 1984, pursuant to Rule 121.

In the notice of deficiency issued to petitioner on August 26, 1980, respondent determined deficiencies in petitioner's Federal income tax as follows:

Year	*Deficiency*
1975 (July 24—Dec. 31)	$90,569
1976	229,699

[1] All section references are to the Internal Revenue Code of 1954 as amended, unless otherwise noted. All Rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise noted.

These deficiencies were attributable to the following adjustments to income determined in the notice of deficiency:

	Taxable year 1975 (July 24—Dec. 31)	*Taxable year 1976 (Year ended Dec. 31)*
Net operating loss deduction decreased	$222,631	$471,323
Legal expense reduced	1,397	0
Charitable contributions decreased (increased)	(7,217)	7,217
	216,811	478,540

The net operating loss, which was decreased in the notice of deficiency issued to petitioner for 1975 and 1976, was a proportionate part of an asserted consolidated net operating loss carryover from 1973. In 1973, petitioner was a member of an affiliated group of corporations that filed a consolidated return. Petitioner seeks a summary adjudication of the issue as to whether Fidelity Corp. (Fidelity),[2] as the parent of the group, was the agent of petitioner authorized and empowered to sign a waiver (Form 4089) agreeing to adjustments which eliminated the consolidated net operating loss for 1973.

For the purposes of this motion, it is agreed that for a period prior to January 1, 1973, and until July 24, 1975, petitioner, then named Craigie, Mason-Hagan, Inc., was a wholly owned subsidiary of Fidelity. Fidelity filed a consolidated Federal income tax return for the calendar year 1973, and petitioner was a component member of the affiliated group. In that year Fidelity itself generated an asserted $25,268,518 net loss. Of that $25,268,518 net loss, $22,172,534 arose from a reported theft loss incurred by reason of an alleged multimillion-dollar swindle by Equity Funding Corp. of America (Equity).

In 1973, when Equity's alleged fraud was discovered, Fidelity owned a large number of the shares of stock of Equity. Because of the enormity of the fraud assertedly perpetrated by Equity, Fidelity's officers, directors, auditors, and accountants believed that there was no reasonable prospect of recovery of the loss sustained by Fidelity. As a consequence, Fidelity deducted the entire amount of $22,172,534 in computing its income in the consolidated return for 1973.

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[2]The name of Fidelity has been changed to Drum Financial Corp., and that name was used in the execution of the waiver here in dispute.

On July 24, 1975, Fidelity sold petitioner to certain officers and employees of petitioner. Thereafter, petitioner filed separate Federal income tax returns. Petitioner carried over and used its allotted portion ($693,954) of the 1973 consolidated net operating loss reported in 1973 as a net operating loss on its separate returns for the years at issue. In so doing, it claimed net operating loss deductions of $222,631 and $471,323 for the years 1975 and 1976, respectively.

Fidelity's consolidated returns for the years 1971 through 1975 were audited by the Internal Revenue Service. The Equity theft loss claimed by Fidelity was disallowed in full for 1973, thereby reducing the consolidated net operating loss carrybacks and carryovers for Fidelity's consolidated taxable years 1971 through 1975. The disallowance of the $22,172,534 Equity loss in 1973 effectively eliminated the net operating loss carryover claimed by petitioner on its separate returns for 1975 and 1976.

The examinations of Fidelity's consolidated income tax returns for the years 1971 through 1975 and petitioner's returns for the years 1975 and 1976 were conducted concurrently. Petitioner was advised by respondent of the proposed disallowance of the 1973 deduction taken by Fidelity for the Equity loss.

On March 10, 1978, petitioner wrote to the District Director at Richmond, Virginia, and advised him of its interest in the audit of Fidelity's 1973 consolidated return. Petitioner further advised the District Director of the circumstances which, because of the conflict of interest, allegedly made it improper for Fidelity to act as agent for petitioner. The District Director answered petitioner's letter on April 21, 1978, stating, in part, that petitioner was entitled to secure a copy of any notice of deficiency and any notice and demand for payment issued to Fidelity. The District Director advised petitioner that Fidelity's tax liability had not been determined; that petitioner's request to be heard was premature; and, that once the audit of Fidelity had been concluded, the two cases would be associated and consideration would be given to petitioner's request at that time.

On December 28, 1979, respondent issued a notice of deficiency to Fidelity in which the claimed Equity loss was disallowed for the taxable year 1973. The notice failed to list

petitioner as one of the members of the affiliated group. On March 26, 1980, Fidelity signed Form 4089, Statutory Notice Statement-Waiver, agreeing that the $22,172,534 Equity loss was not deductible for 1973. The parties have stipulated that Fidelity, due to consolidated net operating losses incurred in various years, was unable to use its consolidated net operating loss for 1973 prior to the taxable year 1976.

On April 18, 1980, petitioner wrote to the District Director calling his attention to the March 10, 1978, letter and respondent's reply of April 21, 1978. On April 30, 1980, the District Director advised petitioner that the examination of Fidelity had been completed and that a copy of the notice of deficiency was being sent to petitioner in accordance with section 1.502–77(b), Income Tax Regs.

Respondent, in his notice of deficiency issued to petitioner on August 26, 1980, determined deficiencies in petitioner's Federal income taxes for the short taxable year July 24, 1975, to December 21, 1975, and the taxable year ended December 31, 1976, in the amounts shown above.

On Schedule 1-A "Explanation of Adjustments," which is attached to the notice, respondent stated the following with respect to the net operating loss deduction:

> You do not have a net operating loss carryover deduction from the consolidated income tax return of Fidelity Corporation for the year ended December 31, 1973. You consented to filing a consolidated income tax return with Fidelity Corporation for that year and upon examination of the return, adjustments were made that eliminated the consolidated net operating loss. Fidelity Corporation signed a Statutory Notice Statement-Waiver on March 26, 1980 agreeing to the adjustments which eliminated the net operating loss. In accordance with regulation 1.1502–77, Fidelity Corporation was the sole agent for each subsidiary in the group and is duly authorized to act in its own name in all matters relating to the tax liability for the consolidated tax year. Accordingly, your taxable income for the years ending December 31, 1975 and December 31, 1976 is increased by $222,631.00 and $471,323.00, respectively.

On November 24, 1980, petitioner filed a timely petition in this Court in which it disputed all of the adjustments enumerated above except the reduced legal expenses. Respondent filed an answer on January 26, 1981. Petitioner subsequently filed the motion for partial summary judgment with supporting memorandum which is now before the Court.

Under Rule 121(b), a motion for summary judgment may be granted if there is no genuine issue as to any material fact and if the moving party is entitled to prevail as a matter of law. *Jacklin v. Commissioner*, 79 T.C. 340, 344 (1982); *Shiosaki v. Commissioner*, 61 T.C. 861, 863 (1974); see *Adickes v. Kress & Co.*, 398 U.S. 114, 157 (1970).

Upon careful consideration of the record before us, we find that the facts of this case are not in dispute, and that as a matter of law Fidelity was authorized to sign Form 4089 consenting to the disallowance of the $22,340,555 loss deduction claimed on the consolidated return for 1973. The motion for partial summary judgment will, therefore, be denied.

Section 1502 provides that "the Secretary or his delegate shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group * * * may be returned." Under this action, the regulations "set forth in elaborate detail how the tax is to be computed in such a return and prescribe the procedure whereby the election of the several corporations is to be manifested." *Davis Bros. Restaurant, Inc. v. Commissioner*, 60 T.C. 525, 532 (1973).

As a prerequisite to filing a consolidated return, the members of the consolidated group must agree to be bound by the regulations governing consolidated returns; section 1501 provides:

> The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent * * *

By filing a consolidated return, petitioner thus consented to be bound by the consolidated return regulations. *Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934). As legislative regulations, those provisions have the force and effect of law unless they are arbitrary. *Union Electric Co. of Mo. v. United States*, 158 Ct. Cl. 479, 305 F.2d 850, 854 (1962); *Covil Insulation Co. v. Commissioner*, 65 T.C. 364, 374 (1975).

Section 1.1502–77(a), Income Tax Regs.,[3] provides that: "The common parent, for all purposes * * * shall be the sole agent for each subsidiary in the group, duly authorized to act in its own name in all matters relating to the tax liability for the consolidated return year." Further, except as to certain enumerated actions, not pertinent here, no subsidiary shall have the authority to act for or to represent itself in any tax matter. That is true "whether or not one or more of the subsidiaries have become or ceased to be members of the group at any time." These express provisions of the regulation clearly negate petitioner's argument that Fidelity was not authorized to bind petitioner when it agreed to the disallowance of the $22,172,534 as a deduction on the consolidated return for 1973.

Yet, petitioner argues that Fidelity was not authorized to act as its agent in respect of the audit of the consolidated return year 1973 on two grounds: (1) That the notice of deficiency issued to Fidelity for the consolidated return years 1971 through 1974 is invalid as to petitioner; and (2) that by its actions petitioner severed the agency relationship for the taxable year 1973, thereby causing the waiver signed by Fidelity to be ineffective as to it.

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[3] Sec. 1.1502–77 is in pertinent part as follows:

Sec. 1.1502–77. Common parent agent for subsidiaries.

(a) *Scope of agency of common parent corporation.* The common parent, for all purposes (other than the making of the consent required by paragraph (a)(1) of section 1.1502–75, the making of an election under section 936(e), the making of an election to be treated as a DISC under section 1.992–2, and a change of the annual accounting period pursuant to paragraph (b)(3)(ii) of section 1.991–(1) shall be the sole agent for each subsidiary in the group, duly authorized to act in its own name in all matters relating to the tax liability for the consolidated return year. Except as provided in the preceding sentence, no subsidiary shall have authority to act for or to represent itself in any such matter. * * * [T]he common parent will file petitions and conduct proceedings before the Tax Court of the United States, and any such petition shall be considered as also having been filed by each such subsidiary. The common parent will file claims for refund or credit, and any refund will be made directly to and in the name of the common parent and will discharge any liability of the Government in respect thereof to any such subsidiary; and the common parent in its name will give waivers, give bonds, and execute closing agreements, offers in compromise, and all other documents, and any waiver or bond so given, or agreement, offer in compromise, or any other document so executed, shall be considered as having also been given or executed by each such subsidiary. * * * The provisions of this paragraph shall apply whether or not a consolidated return is made for any subsequent year, and whether or not one or more subsidiaries have become or have ceased to be members of the group at any time. Notwithstanding the provisions of this paragraph, the district director may, upon notifying the common parent, deal directly with any member of the group in respect of its liability, in which event such member shall have full authority to act for itself.

Assuming, arguendo, that the notice of deficiency was invalid, as to petitioner,[4] we do not think that, as a result, the waiver signed by Fidelity is likewise defective as to petitioner. We fail to see any such connection between the notice and the waiver.[5]

On March 26, 1980, several days before the 90-day period was to run, Fidelity signed the waiver agreeing to the immediate assessment of the deficiencies determined for the consolidated return years 1971 through 1974. In doing so, Fidelity agreed that the $22,172,534 Equity loss was not deductible for 1973. As a practical result, this agreement meant that there was no longer any consolidated net operating loss carryover to be allocated to petitioner for the 1975 and 1976 separate income tax years in issue before the Court.

Section 1.1502–77(a), Income Tax Regs., states that:

> *the common parent in its name will give waivers* * * * and execute * * * all other documents, and any waiver * * * so given, or agreement, * * * or any other document so executed, shall be considered as having also been given or executed by each such subsidiary. * * * The provisions of this paragraph shall apply * * * whether or not one or more subsidiaries have become or have ceased to be members of the group at any time. [Emphasis added.]

By filing a consolidated return, petitioner agreed to be bound by such regulations. Moreover, petitioner agreed, according to the regulations, to let Fidelity serve as its agent for "all matters relating to the tax liability for the consolidated return year."[6]

Had fidelity agreed to the disallowance of the 1973 loss at any time prior to the issuance of the notice of deficiency, and signed a waiver or other agreement respecting that agree-

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[4]Sec. 1.1502-77, Income Tax Regs., includes the following:

"Notwithstanding the provisions of this paragraph, any notice of deficiency, in respect of the tax for a consolidated return year, will name each corporation which was a member of the group during any part of such period (but a failure to include the name of any such member will not affect the validity of the notice of deficiency as to the other members)."

We need not decide whether the notice of deficiency in this case was valid as to petitioner.

[5]Respondent has conceded that, if the notice of deficiency was invalid as to petitioner, the Government is precluded from assessing petitioner for the liability asserted in the 1971–74 notice of deficiency mailed to Fidelity. Respondent states that:

"If the 90-day period expired without action, [respondent would not] be able to assess the tax based on the Fidelity notice against the petitioner and would not be able to demand payment from it for the taxes determined for the years covered in the Fidelity notice. As a result of the foregoing, since there would be no valid assessment against the petitioner, the respondent would be unable to file a lien or levy on any of petitioner's property with respect to Fidelity's taxes."

[6]See generally *Southern Pacific Co. v. Commissioner*, 84 T.C. 395 (1985).

ment, there would be no doubt as to the validity of that document. The common parent's broad agency power dictates that no other conclusion may be reached. Whether or not the notice of deficiency is ineffective as to one party or another does not have any bearing on the validity of the waiver as to the affiliated group. The waiver stands alone. We can see no justifiable difference between Fidelity's authority to sign a waiver before the notice of deficiency was issued and its authority to sign a waiver after the notice of deficiency was issued.

We think petitioner's second argument—that petitioner severed the agency relationship for 1973 thereby causing the waiver to be ineffective—is equally without merit. The fact that petitioner ceased to be a member of the group did not cause a termination of the agency relationship. The regulations provide that if a subsidiary has ceased to be a member of the group and if it files notice of such cessation with the District Director, the District Director may furnish the subsidiary with a copy of any notice of deficiency issued to the parent corporation. Sec. 1.1502–77(b), Income Tax Regs.[7] The District Director did so in this case in accordance with the correspondence reviewed above. But the regulation further provides that: "The filing of such written notification and request by a corporation shall not have the effect of limiting the scope of the agency of the common parent." Thus, Fidelity's authority to sign the waiver for the affiliated group for 1973 was not affected by petitioner's correspondence with the District Director.

The regulations do provide for a situation where the District Director may deal directly with a subsidiary, thereby causing the agency relationship between the parent and the subsidiary to cease. Section 1.1502–77(a), Income Tax Regs., provides:

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[7] Sec. 1.1502–77(b), Income Tax Regs., provides as follows:

(b) *Notification of deficiency to corporation which has ceased to be a member of the group.* If a subsidiary has ceased to be a member of the group and if such subsidiary files written notice of such cessation with the district director with whom the consolidated return is filed, then such district director upon request of such subsidiary will furnish it with a copy of any notice of deficiency in respect of the tax for a consolidated return year for which it was a member and a copy of any notice and demand for payment of such deficiency. The filing of such written notification and request by a corporation shall not have the effect of limiting the scope of the agency of the common parent provided for in paragraph (a) of this section and a failure by such district director to comply with such written request shall not have the effect of limiting the tax liability of such corporation provided for in section 1.1502–6.

Notwithstanding the provisions of this paragraph, the district director may, upon notifying the common parent, deal directly with any member of the group in respect of its liability, in which event such member shall have full authority to act for itself.

Petitioner's correspondence with the District Director did not effect a termination of the agency relationship between Fidelity and petitioner under this regulation. The District Director's communications with petitioner did not indicate an intention by the Government to deal directly with petitioner on the issue of the 1973 taxable year loss. Moreover, to terminate the agency relationship, the regulations require that notification be given by the District Director to the common parent. Petitioner has not shown that any such notification was ever given. Fidelity remained the authorized agent of petitioner for Federal tax purposes relating to the taxable year 1973. Therefore, we find that the waiver was duly executed by Fidelity as an authorized agent of petitioner and both Fidelity and petitioner are bound by its terms.

We recognize that our conclusion that Fidelity's waiver is valid produces a result that may be disappointing to the interests that acquired petitioner in July 1975, when petitioner's affiliation with Fidelity was terminated. The privilege of electing to file consolidated returns, however, is limited to corporations with a carefully defined parent-subsidiary relationship. As in this case, the relationships between component members of a group may change and their interests may become diverse. Practical problems in the administration of the tax laws would arise if each corporation, after terminating its affiliation with the group, could pursue its own interests with respect to the handling of consolidated returns filed during the period of affiliation. For this reason, no doubt, the regulations precisely define and carefully limit the circumstances in which a parent corporation's agency authority may be terminated. An election to file a consolidated return carries with it burdens as well as benefits and, as we have stated in other contexts, each member of the group must "take the bitter with the sweet." *Georgia-Pacific Corp. v. Commissioner*, 63 T.C. 790, 802 (1975); *First National Bank in Little Rock v. Commissioner*, 83 T.C. 202, 217 (1984).

Petitioner's motion cannot be granted.

To reflect the foregoing,

An appropriate order will be issued.

BANC ONE CORPORATION, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 10756-80. Filed March 28, 1985.

P acquired two banks at prices exceeding the aggregate book values of the assets reported in the financial statements of the acquired banks. *Held*, petitioner is not precluded from allocating the aggregate purchase prices among the acquired assets even though such allocations were not negotiated or calculated at the time of the acquisitions. *Held, further*, depreciation deductions claimed by P with respect to a "loan premium" denied because P failed to establish basis in excess of book value for the loans. *Held, further*, P is not entitled to depreciation deductions with respect to core deposits because hindsight statistics were the only evidence submitted by P to calculate depreciation. *Held, further*, value of goodwill and other nondepreciable intangibles acquired by P determined under the residual method.

Charles J. Kegler, Paul D. Ritter, Jr., and *Edward C. Hertenstein*, for the petitioner.
Eugene P. Bogner, for the respondent.

COHEN, *Judge*: Respondent determined deficiencies in petitioner's income tax liability of $455,263 for the tax year ended 1974 and $967,265 for the tax year ended 1975. The issues for decision are as follows: (1) Whether petitioner should be allowed depreciation deductions under section 167[1] with respect to either loan or deposit premiums allegedly acquired in the purchase of two banks, and (2) whether petitioner properly allocated the aggregate purchase prices of the two banks among the individual assets acquired in proportion to the relative values of the assets as determined by petitioner (the "second tier" allocations).

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[1]Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Prior to October 19, 1979, petitioner was known as First Banc Group of Ohio, Inc. Petitioner and its predecessor shall hereinafter collectively be referred to as "petitioner."

Petitioner is a corporation and had its principal place of business in Columbus, Ohio, at the time of filing the petition herein. Petitioner and its subsidiaries filed consolidated Federal income tax returns for the calendar years 1974 and 1975 with the Internal Revenue Service Center in Cincinnati, Ohio.

Petitioner was a registered bank holding company under the Bank Holding Act of 1956 and owned substantially all of the shares of a number of commercial banks in Ohio. Through its subsidiaries, petitioner acquired additional Ohio banks. This case concerns the acquisition of the Athens National Bank (Old Athens) and the First Citizens Bank (First Citizens).

Old Athens

Prior to September 13, 1974, Old Athens operated a main office facility and four branch offices in or near Athens, Ohio. Athens was the county seat of Athens County, a rural county in southeastern Ohio and the home of Ohio University. As of December 31, 1973, Old Athens was the largest of eight banks doing business in Athens County. Old Athens had deposits of $40.3 million, and the next largest bank had deposits of $15 million on that date. The other six banks in Athens County had aggregate deposits of approximately $48 million on December 31, 1973.

Prior to September 13, 1974, all of the shares of Old Athens were owned by United Dairy Farmers Investment Co. (United Dairy), a partnership whose principal office was in Cincinnati, Ohio, and whose principal partners were Carl H. Lindner (Lindner) and Robert D. Lindner. The board of directors of Old Athens consisted of its president, Brandon Tad Grover (Grover), and four Cincinnati residents, including Lindner, who were affiliated with United Dairy. Employed by Old Athens since 1952 and named president in 1965, Grover was the bank's sole executive-level manager, and he worked under the

close and continuing direction of the Cincinnati board members and owners.

Old Athens derived virtually all of its deposits from within Athens County. Grover, who was a member of the Athens City Council and an active participant in a variety of community-oriented activities, had acquired the deposit accounts of the majority of the businesses in Athens County.

The Cincinnati owners required Old Athens to enter into a number of loans and leases with customers from the Cincinnati area. Because Old Athens placed priority upon servicing the lending, leasing, and other banking requirements of the Cincinnati customers, the bank frequently refused or curtailed banking services to existing and prospective local customers.

Although Grover had no concern for the credit worthiness of the Cincinnati customers, he resented being forced by the owners to engage in the transactions. Grover believed that Old Athens could make additional and very profitable loans to customers in Athens County, if funds were not used in the Cincinnati loans and leases. Grover thus desired the acquisition of Old Athens by a holding company that would allow him to run a community-oriented bank on an aggressive and profitable basis.

In early 1973, Lindner contacted petitioner's chief executive officer and proposed the sale of Old Athens to petitioner. An associate of Lindner visited petitioner's office in Columbus, Ohio, in late summer of 1973 to discuss further the possible acquisition. Lindner's representative proposed a sales price of $13 million for Old Athens.

Sometime before October 11, 1973, petitioner reached an oral agreement in principle with Lindner for the purchase of Old Athens. On that date, several officers of petitioner met with Grover at Old Athens' offices. Petitioner's officers thereafter acquired additional information concerning Old Athens that became the basis of several written internal evaluations of the proposed transaction. These evaluations included a memorandum of October 12, 1973, prepared by petitioner's officer in charge of acquisitions, which described Old Athens' market, organizational and operational structure, and assets and liabilities, including loans and deposits.

During October and November of 1973, petitioner's assistant treasurer prepared several reports analyzing the financial

READEX FICHE

effect upon petitioner of the acquisition of Old Athens and determining petitioner's return on investment at various assumed acquisition prices. A primary objective of these reports was to ensure that the acquisition of Old Athens would not dilute petitioner's per-share earnings. The accuracy of the financial projections thus depended upon the assistant treasurer's ability to determine Old Athens' "normalized" net income, i.e., the expected continuing earnings of Old Athens based upon petitioner's accounting standards. In computing Old Athens' normalized earnings, petitioner's assistant treasurer considered Old Athens' loans and deposits and treated the excess of the assumed purchase prices over Old Athens' book value as "goodwill," to be amortized over 40 years.

On March 20, 1974, the F.B.G. National Bank of Athens (F.B.G.) was organized as a national banking association in which petitioner owned substantially all the shares. Old Athens, United Dairy, F.B.G., and petitioner entered into a merger agreement dated May 17, 1974, providing for the merger of Old Athens into F.B.G. The merged entity was to be renamed "The Athens National Bank" (New Athens). New Athens was to pay $10 million to the shareholders of Old Athens and to assume all of Old Athens' liabilities on the effective date of the merger. The merger agreement did not allocate the purchase price among the various assets to be acquired as a result of the merger. United Dairy agreed not to employ Grover in any capacity within 5 years after the effective date.

The obligations of petitioner (and thus of New Athens) under the agreement were subject to a number of express conditions. Among these was that there be no material adverse change in the financial position, business, or aggregate net assets of Old Athens from June 30, 1973, until the effective date of the merger. The purpose of this condition was to allow petitioner to avoid closing the transaction, if the financial condition of Old Athens at closing were materially worse than petitioner's expectations. Additionally, petitioner's obligations were contingent upon the payment in full, prior to the effective date, of the loans made by Old Athens to the Cincinnati borrowers.

On May 24, 1974, petitioner filed with the Comptroller of the Currency an application for approval to merge Old Athens

into F.B.G. Petitioner noted in the application that a condition precedent to consummation of the merger was that Old Athens' loans to Cincinnati customers, which aggregated approximately $5.13 million, be paid in full. Petitioner also stated that Old Athens held approximately $3 million in leveraged leases and equipment leases derived from transactions originated by the Cincinnati owners. Although these leases were to remain with New Athens after the merger, petitioner represented that New Athens would not participate in additional leveraged leasing and would engage in equipment leasing only to accommodate customers from the Athens area. According to petitioner, freeing New Athens from the credit and leasing requirements of the Cincinnati customers would allow the bank to satisfy better those needs of its local customers.

Between May 17, 1974, and September 13, 1974, petitioner sent auditors to Old Athens to perform a cursory review of the deposits, loans, and operations of the bank. Sometime after May 24, 1974, petitioner performed a preclosing examination of Old Athens. No change in the merger agreement resulted from petitioner's examinations.

The merger was consummated on September 13, 1974, at which time New Athens paid $10 million in cash and assumed all of Old Athens' liabilities (including investment tax credit recapture) totaling $39,266,812, for a total consideration of $49,266,812.

New Athens accounted for the merger under the "purchase" method for financial accounting purposes. New Athens thus attempted to record the assets transferred from Old Athens at their estimated fair market values. By this process, New Athens reduced the aggregate carrying value of the various loan portfolios (commercial, real estate, etc.) as reflected in Old Athens' financial records by $389,000. The stated purpose for this reduction was "to adjust the interest rates on loans to current rates charged by the bank." The average yields on the loan portfolios acquired from Old Athens generally were lower than the prevailing market rates at the time of the merger.

After restating each asset account to reflect its estimated fair market value, New Athens assigned the amount by which the purchase price exceeded the sum of the restated asset accounts (net of the related expected tax benefit) to an account

entitled "cost in excess of fair market value." New Athens expensed this account as a current charge in preparing the financial statements required by banking regulatory authorities. In petitioner's 1974 and 1975 annual report to shareholders, however, the "cost in excess" account was reported as an "other asset," to be amortized over a period not to exceed 40 years.

Petitioner secured a ruling from the Internal Revenue Service dated December 31, 1974, that, for Federal income tax purposes, the merger constituted a purchase by New Athens of the assets of Old Athens, and New Athens' bases in the acquired assets equaled their cost. The ruling also stated that, assuming certain exceptions did not apply, Old Athens would not recognize gain or loss, and Old Athens' shareholders would be treated as receiving the $10 million cash in full payment in exchange for their shares.

Petitioner engaged the accounting firm of Coopers & Lybrand (Coopers) to determine New Athens' bases for Federal tax purposes in the assets acquired from Old Athens. Coopers' task thus was to allocate the $49,266,812 purchase price among such assets. Coopers' work began in February or March of 1974 and culminated in a report dated December 31, 1974. The stated objective of Coopers' report was "An allocation of the purchase price in proportion to the fair market value of the assets."

The allocation in Coopers' report consisted of a two-step process. Coopers first allocated to each asset the amount that Coopers determined to be the fair market value of the asset. Because Coopers determined the aggregate fair market value of the individual assets to be $46,168,774, $3,098,038 of the purchase price remained unallocated after this first step. In the second step, Coopers allocated the $3,098,038 among all the assets except cash and cash equivalents in proportion to the relative values determined in the first step.

Coopers' determinations of the fair market values of the various assets generally corresponded with the values utilized by New Athens for financial accounting purposes, with two exceptions herein relevant—loans and goodwill.

Coopers assigned values to the various loan portfolios through "loan spreading." On forms created for the spreading process, personnel at Old Athens listed for each loan by

portfolio the name of the borrower, the principal balance due (i.e., the book value from Old Athens' financial records), and a rating of A+, A, B, or C. Coopers and Old Athens personnel jointly determined the factors to be used in rating the loans. Although the factors varied somewhat depending on loan type, the basic criteria were the term, yield, and original amount of the loan, the likelihood of payment on the loan, and whether the borrower had deposits with or received other services from Old Athens. Grover reviewed the completed forms and transferred them to Coopers. Coopers then determined a premium or discount percentage to be applied to the balance due on each loan depending upon the loan's rating. Coopers valued the loans rated A+ at a 20-percent premium over the balance due, the A loans at a 10-percent premium, the B loans equal to the balance due, and the C loans at a 10-percent discount from the balance due. The net effect of these adjustments was to increase the aggregate loan balance by $2,675,369 over the amount reported by Old Athens on the effective date of the merger.

Coopers also determined a value for "goodwill and other intangibles" during the first step in its allocation process. Coopers stated in its report that the value assigned to this account was computed in accordance with Rev. Rul. 68–609, 1968–2 C.B. 327.

From Old Athens' financial statements, Coopers ascertained the following income and capital figures:

Year	*Total operating income*	*Net earnings after tax and before security transactions*	*Yearend total capital plus reserves*
1973	$3,356,597	$693,330	$4,558,936
1972	3,139,252	707,958	3,872,984
1971	2,631,559	561,484	2,991,836
1970	2,278,540	521,712	2,699,590
1969	1,876,519	254,151	2,792,528
Total	13,282,467	2,738,635	16,915,874
Average	2,656,493	547,727	3,383,175

Based upon a comparison of Old Athens' commercial loan rates for the years 1969 through 1973 with the commercial rates of "three similar country banks," Coopers found Old Athens' rates to have been 1 to 2 percent higher during the period. Coopers concluded that the Cincinnati loans enabled

Old Athens to earn "a higher commercial loan rate than is customary for a country bank," and determined that Old Athens' loan income would probably have been an average of approximately $115,000 lower each year had the bank not engaged in the Cincinnati loans. Coopers further determined that Old Athens earned approximately $100,000 per year during 1971 through 1973 from the Cincinnati leases that it otherwise would not have earned. To reflect these determinations, Coopers restated the figures reported in Old Athens' financial statements as follows:

Year	*Adjusted total operating income*	*Adjusted net earnings after tax and before security transactions*	*Adjusted yearend total capital plus reserves*
1973	$3,115,597	$520,010	$3,959,416
1972	2,909,252	540,358	3,446,784
1971	2,440,559	414,164	2,733,236
1970	2,180,540	470,752	2,588,310
1969	1,760,519	193,831	2,732,208
Total	12,406,467	2,139,115	15,459,954
Average	2,481,293	427,823	3,091,991

Based upon statistics from the Federal Reserve Bulletin for September 1974, Coopers determined that the normal rate of return (computed as net income after taxes and before security transactions divided by capital plus reserves) of banks of Old Athens' size and location was 11.95 percent. Multiplying Old Athens' average adjusted capital of $3,091,991 by the 11.95-percent rate, Coopers determined that a "normal return" for a bank like Old Athens was $369,493, and that Old Athens earned an average "excess return" of $58,330 each year (Old Athens' average adjusted net earnings of $427,823 less $369,493). Coopers then capitalized the average annual excess return figure at twice the 11.95-percent rate, to yield a value for the "goodwill and other intangibles" of Old Athens of $244,059.

The following table illustrates Coopers' allocation of the aggregate purchase price of Old Athens:

Asset acquired	Book value per Old Athens	Increase or (Decrease) to FMV	FMV as determined by Coopers	Allocation of excess of cost over FMV	Tax basis
Cash	$5,088,735	- - -	$5,088,735	- - -	$5,088,735
Federal funds sold	700,000	- - -	700,000	- - -	700,000
U.S. Government obligations	9,414,272	($69,738)	9,344,534	$708,825	10,053,359
Federal agency securities	2,203,751	(142,124)	2,061,627	156,384	2,218,011
Municipal bonds	963,357	(18,579)	944,778	71,666	1,016,444
Federal Reserve stock and other securities	197,617	(9,692)	187,925	14,255	202,180
Commercial loans	4,414,644	680,135	5,094,779	386,463	5,481,242
Real estate loans	5,832,213	1,056,463	6,888,676	522,538	7,411,214
Floor plan loans	569,961	111,692	681,653	51,707	733,360
Installment loans	7,893,861	678,266	8,572,127	650,235	9,222,362
Other installment loans	1,151,538	148,813	1,300,351	98,638	1,398,989
Other loans	1,178,371	- - -	1,178,371	89,385	1,267,756
Land	109,394	20,856	130,250	9,880	140,130
Building	782,469	90,666	873,135	66,232	939,367
Equipment	342,570	55,003	397,573	30,158	427,731
L/H improvements	27,940	(27,940	- - -	- - -	- - -
Depreciation reserve	(153,784)	153,784	- - -	- - -	- - -
Interest earned, not collected	388,626	- - -	388,626	29,479	418,105
Prepaid expenses	66,176	- - -	66,176	5,020	71,196
Braniff lease	1,237,415	(533,603)	703,812	77,344	781,156
American lease	666,166	(341,050)	325,116	35,728	360,844
Sci Tek lease	543,374	136,754	680,128	51,591	731,719
Levinson lease	213,003	(34,826)	178,177	13,516	191,693
Other leases	138,166	- - -	138,166	10,481	148,647
Goodwill	- - -	244,059	244,059	18,513	262,572
	43,969,835	2,198,939	46,168,774	3,098,038	49,266,812

The liabilities of Old Athens assumed by New Athens on the effective date of the merger included the following liabilities for deposits:

Type	Amount
Demand deposits	$13,233,692
Savings deposits	6,659,401
Due to other banks	74,118
Public funds	4,894,003
Nonnegotiable certificates of deposit	13,592,158

The demand deposits were non-interest-bearing checking accounts. The savings deposits included three types of savings plans: (1) Receipt savings accounts bearing interest subject to regulatory limits and requiring no minimum term or minimum balance; (2) moneytree accounts bearing interest subject to regulatory limits and requiring no minimum balance, but

requiring a 90-day minimum term; and (3) 3-month savings plans requiring a $1,000 minimum balance and a 90-day minimum term and bearing interest at an optional guaranteed rate for 5 years.

Public funds comprised approximately 18 percent of Old Athens' total deposits. These funds included accounts of various agencies of the United States, the State of Ohio, and the County and City of Athens.

Old Athens' deposit accounts varied substantially in size. A relatively small percentage of the depositors thus accounted for a relatively large percentage of the total deposits. For example, on June 30, 1972, 168 of 24,254 deposit accounts represented over $12.5 million of approximately $36.5 million in deposits.

Of the 69 employees of Old Athens on September 13, 1974, 68 were employed by New Athens after the merger, and 23 remained employed as of April 30, 1984. Although Grover did not enter into an employment contract with New Athens after the merger, as of the date of trial, he remained president without interruption.

New Athens continued to use the name "Athens National Bank" until it was renamed "Bank One of Athens N.A." on October 22, 1979.

The financial statements of Old Athens for the years 1971 through 1973 and New Athens for the years 1974 through 1976 reported the following amounts as "interest and fees on loans":

Year	*Amount*	*Year*	*Amount*
1971	$1,393,801	1974	$2,098,990
1972	1,811,127	1975	2,005,000
1973	2,015,358	1976	2,289,000

First Citizens

In July of 1970, First Citizens operated a single office in Oxford, Butler County, Ohio. First Citizens was the second smallest of seven banks operating 32 offices in Butler County.

Both the main campus of Miami University and that of Western College were located in Oxford, and more than half of Oxford's 1970 population of 15,868 were students at these institutions. Although Butler County contained two urban

industrial centers, the schools were the primary economic enterprises in Oxford. Oxford lacked transportational accessibility, and the community exerted little effort to attract additional businesses.

The Barnitz Bank (Barnitz) was a subsidiary of petitioner engaged in banking in the Butler County city of Middletown. In July of 1970, the president of Barnitz and the president of First Citizens began discussing a stock merger of First Citizens into Barnitz. Allen Welsh (Welsh), First Citizens' president, wished to retire and believed that First Citizens lacked successor management and therefore could not continue to operate as an independent bank. After First Citizens' loan portfolio developed problems and received increased regulatory scrutiny, Welsh resumed discussions with Barnitz' president in February of 1971. The discussions continued until June 1972, when Welsh and the president of Barnitz agreed that Barnitz would submit an offer to First Citizens' board of directors in August or September of that year. Before Barnitz could present the offer, however, Welsh died in the fall of 1972.

Following Welsh's death, Don Teetzel (Teetzel) became president of First Citizens, even though, by his own appraisal, Teetzel lacked the capacity and interest for the position. Teetzel spent substantially all of his term as president in the hospital and died in March of 1973.

The board of directors of First Citizens recognized during this time that the bank confronted problems that necessitated an acquisition by a larger bank. In addition to the deaths of Welsh and Teetzel, First Citizens suffered from the failure to adhere to sound credit policies and a highly congested office facility that lacked parking and both drive-in and after-hours banking. First Citizens' most immediate operating concern became effecting recoveries on a large number of problem loans. The board members therefore continued the negotiations with Barnitz and initiated negotiations with four additional banks.

Several of First Citizens' directors also attempted to arrange a syndicate of local investors to purchase the stock of any shareholders wishing to receive cash. Although the attempt was unsuccessful, the board learned that substantially all of the shareholders desired cash instead of an exchange of shares.

In March of 1973, Barnitz and three other banks submitted cash bids for the purchase of First Citizens. Barnitz' bid substantially exceeded each bid of the other banks.

Barnitz and First Citizens executed a purchase agreement dated May 1, 1973, in which Barnitz agreed to purchase all the assets of First Citizens in exchange for cash and the assumption of all of First Citizens' liabilities. The amount of cash payable on the closing date was $1,576,935, plus an additional amount based upon the recovery of certain loans, but in no event to exceed $1,825,005. The purchase agreement did not allocate the purchase price among the assets to be acquired by Barnitz. First Citizens agreed to adopt a plan of complete liquidation after closing.

The asset purchase was consummated on December 31, 1973, and on that date Barnitz paid First Citizens $1,620,510 in cash and assumed liabilities of $9,821,474, for a total purchase price of $11,441,984.

For financial accounting purposes, Barnitz attempted to restate the asset accounts as carried on First Citizens' books to reflect market values. Barnitz made no adjustments to the loan accounts during this process. Barnitz allocated the amount by which the purchase price exceeded the sum of the restated asset accounts (net of expected tax benefit) to "cost in excess of fair market value." This amount was expensed in Barnitz' financial statements pursuant to regulatory requirements but reported in petitioner's financial statements as an "other asset," to be amortized over a period not to exceed 40 years.

Petitioner engaged Coopers to determine Barnitz' bases for Federal tax purposes in the assets acquired from First Citizens. Coopers employed a two-step process similar to that utilized in connection with the Old Athens transaction. In allocating a portion of the purchase price to each asset equal to its estimated market value (the first step of the process), Coopers recognized three assets not carried on the books of First Citizens or recorded by Barnitz for financial accounting purposes. These assets were "bank charter," "trade name," and "going concern value," to which Coopers allocated $1,035, $25,000, and $40,000, respectively. Coopers made no allocation to loan premiums or goodwill. Coopers concluded that First Citizens possessed no goodwill in part because Coopers deter-

mined the bank's earnings to be below the average for similar banks.

After the first step of the process, the purchase price exceeded the restated asset accounts by $634,972. In the second step, Coopers allocated this amount among all assets except cash and cash equivalents in proportion to their relative values as determined in the first step.

The following table illustrates Coopers' allocation of the aggregate purchase price of First Citizens:

Asset acquired	*Book value per First Citizens*	*Increase or (decrease) to FMV*	*FMV as determined by Coopers*	*Allocation of excess of cost over FMV*	*Tax basis*
Federal income tax refund	$14,078	($12,877)	$1,201	- - -	$1,201
Cash and due from banks	1,886,810	- - -	1,886,810	- - -	1,886,810
U.S. bonds and obligations	458,017	1,976	459,993	$48,639	508,632
U.S. agencies	200,250	- - -	200,250	21,145	221,395
Municipals	1,184,009	16,244	1,200,253	126,867	1,327,120
Federal funds sold	2,900,000	- - -	2,900,000	- - -	2,900,000
Commercial loans	2,980,277	- - -	2,980,277	315,010	3,295,287
Mortgage loans—conventional	101,907	- - -	85,000	8,953	93,953
Mortgage loans—FHA		- - -	16,907	1,778	18,685
Installment loans	725,020	- - -	725,020	76,641	801,661
Land	81,125	104,775	30,000	3,175	33,175
Buildings			110,000	11,620	121,620
Furniture and fixtures			45,900	4,826	50,726
Accrued loan interest	65,667	- - -	65,667	6,921	72,588
Purchase interest	21,773	- - -	10,397	1,079	11,476
Accrued bond interest		- - -	11,376	1,143	12,519
Series E bonds redeemed	11,926	- - -	10,959	- - -	10,959
Prepaid insurance		- - -	967	127	1,094
Bank charter	- - -	1,035	1,035	127	1,162
Trade name	- - -	25,000	25,000	2,667	27,667
Going-concern value	- - -	40,000	40,000	4,254	44,254
	10,630,859	176,153	10,807,012	634,972	11,441,984

The liabilities of First Citizens assumed by Barnitz on the effective date of the acquisition included the following liabilities for deposits:

Type	*Amount*
Demand deposits	$5,787,309
U.S. Government deposits (demand)	231,495
Savings accounts	3,703,118
Nonnegotiable certificates of deposit	48,500

The demand deposits were non-interest-bearing checking accounts. The Government deposits were generally noninterest-bearing Treasury tax and loan deposits. The savings accounts included passbook accounts bearing interest subject to regulatory limits and requiring no minimum term or minimum balance, and savings plus accounts bearing interest subject to regulatory limits and requiring a minimum term of 90 days and a minimum balance of $1,000.

On the effective date of the acquisition, First Citizens became a branch of Barnitz, doing business as the "First Citizens' Branch of the Barnitz Bank." On October 22, 1979, Barnitz' name was changed to "Bank One of Middletown."

Of the 12 employees of First Citizens on December 31, 1973, 11 were employed by Barnitz after the acquisition, and 5 remained employed as of April 30, 1984.

First Citizens realized "operating income" before the acquisition as follows:

Year	*Amount*
1972	$119,900
1971	111,800
1970	121,500
1969	160,800
1968	76,700

Additional Facts Relating to Depreciation

On its income tax returns for the years in issue, petitioner reported depreciation deductions with respect to certain assets acquired from Old Athens and First Citizens. Petitioner used the amounts assigned by Coopers to the various assets in the purchase price allocations as its bases for depreciation of the assets.

In the statutory notice of deficiency, dated April 1, 1980, respondent determined that the excess of the purchase prices of Old Athens and First Citizens over the pre-existing book values of the acquired assets represented goodwill and other intangibles. Respondent disallowed petitioner's deductions for the years 1974 and 1975 to the extent that the deductions were based upon costs in excess of such book values.

In its petition filed with the Court on June 20, 1980, petitioner relied on the process used by Coopers to support its bases in the assets acquired from Old Athens and First

Citizens. On April 23, 1984, petitioner filed amendments to the petition in which it alleged in the alternative that it acquired from Old Athens and First Citizens a "deposit premium," which was a depreciable intangible asset.

Core deposits are the checking and savings deposits of a commercial bank and represent the primary resource with which the bank earns profit. The bank typically invests the funds from deposits in loans and other income-producing assets and receives fees for services rendered to its depositors. The bank also incurs various expenses in establishing, processing, and maintaining the deposit accounts. The excess of the income generated by savings and checking account funds over the associated costs of those accounts represents the profit attributable to the core deposits. Thus the economic value of core deposits rests upon their ability to generate a stream of earnings over time. Often the assumption of the deposit liabilities, rather than the purchase of the assets, represents the economic purpose behind the acquisition of a bank.

Deposit accounts do not remain permanently with a bank, but close for a variety of reasons. For individual accounts, these reasons include the death, marriage, and divorce of the depositors. For business accounts, the reasons include the reorganization and bankruptcy of the depositors. Both individual and business accounts may terminate because of the relocation of the depositors and the acquisition of the accounts by a competing bank. It is not possible to predict accurately when a particular deposit account will leave a bank. Statistical analysis can be utilized, however, to estimate the percentage of accounts in the total deposit base that will close over a given period of time.

In December of 1981, petitioner engaged Patten, McCarthy & Associates, Inc. (PM), a bank consulting firm, to prepare statistical reports analyzing the core deposits acquired from Old Athens and First Citizens. The reports were dated March 12, 1984, with respect to Old Athens, and March 22, 1984, with respect to First Citizens. In the reports, PM valued the total core deposits acquired from Old Athens at $3,009,909, and from First Citizens, at $1,434,797, as of the respective acquisition dates.

The PM reports also contained "amortization schedules" for the acquired core deposits. To prepare the amortization sched-

ules, PM first selected sample accounts from the account records as of the end of each year for 5 consecutive years. With respect to First Citizens, PM chose the sample accounts from the account records as of the end of the years 1973 through 1977. In implementing a computer accounting system in 1976, New Athens changed the identification numbers of its deposit accounts. PM therefore selected the samples from New Athens' account records as of the end of the years 1976 through 1980. The statistical accuracy of both reports was "conditional on the sample of accounts selected."

After grouping the sample accounts for each year by age (i.e., the length of time the account had been with the bank), PM followed each sample account throughout the 4-year sample period to determine whether and when the account closed during the period. From this information, PM estimated the rates at which the acquired core deposits would close over time. PM then applied these rates to the values it determined for the core deposits to compute the amount of amortization each year after the acquisition. The amortization period for Old Athens extended for 21 years with respect to checking accounts, and 11 years with respect to savings accounts. The period for First Citizens extended for 40 years with respect to checking accounts, and 20 years with respect to savings accounts. Because the account termination rates calculated by PM were highest during the early years, the amortization schedules resulted in 60 percent of the core deposit value (as determined by PM) of Old Athens, and 51 percent of that of First Citizens being amortized during the first 3 years after the acquisition.

OPINION

Issue 1: Depreciation of Loan or Deposit Premiums

Through its subsidiaries, petitioner purchased two operating banks at prices exceeding the book values reported in the financial records of the acquired banks. Petitioner contends that a portion of the excess purchase price of Old Athens should be allocated either to a "loan premium" or to a "core deposit intangible," both of which petitioner argues are depreciable intangible assets. Petitioner raises only the core deposit argument with respect to the acquisition of First Citizens.

Respondent asserts that the amounts attributed by petitioner to depreciable intangibles should, instead, be allocated to goodwill, going concern value, or some other nondepreciable asset.

Section 167(a) allows as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or held for the production of income. Section 1.167(a)-3, Income Tax Regs., provides for the depreciation of certain intangible property:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

To qualify for a depreciation deduction with respect to an intangible asset, petitioner thus must prove that the asset (1) had an ascertainable cost basis separate from goodwill and going concern value and (2) had a useful life, the duration of which could be ascertained with reasonable accuracy. *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973); *L.A. Central Animal Hospital v. Commissioner*, 68 T.C. 269 (1977). Whether petitioner has satisfied these requirements is essentially a factual question. *Computing & Software, Inc. v. Commissioner*, 64 T.C. 223 (1975).

Respondent first argues that under *Southern Bancorporation v. United States*, 732 F.2d 374 (4th Cir. 1984), petitioner cannot use the analyses of Coopers and PM to establish its cost bases in the loan premium and the core deposit intangibles because "the loan spreading process had no bearing on the determination of the purchase price and was not included in the negotiations toward the purchase price between the buyer and seller" and "There is no evidence whatsoever that the two sellers involved in this case and the petitioner negotiated as to the value of this alleged core deposit premium." In *Southern Bancorporation*, the Fourth Circuit Court of Appeals declined to allow the purchaser of a bank to increase the bases of acquired loans pursuant to loan spreading.

> Section 1012 of the Internal Revenue Code, 26 U.S.C. sec. 1012, provides that the basis of property shall be the cost of property. On the approach adopted by * * * [the taxpayer], there was not an assignment of values to the various components of the deal. Thus, it is difficult to say what the costs of the loan portfolios were.
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> * * * [The taxpayer's] attempt to increase the bases of the loan portfolios is wholly *post hoc*. A purchaser must prove the purchase price, i.e., the cost, at the time of sale. *See, e.g. Markham & Brown, Inc. v. United States*, 648 F.2d 1043, 1046 (5th Cir. 1981); *Better Beverages, Inc. v. United States*, 619 F.2d 424, 429–30 *reh'g denied*, 625 F.2d 1160 (5th Cir. 1980). * * * [The taxpayer] introduced no evidence to prove that it intended to pay an enhanced value for the loan portfolios *at the time of sale*. The Fifth Circuit said in *Better Beverages*: "A taxpayer's failure of proof on this point may not be overcome by abstract arguments, not tethered to the fact of the transaction, as to what *might* have been a fair and equitable price of apportionment." 619 F.2d at 430 (emphasis in original).
>
> [*Southern Bancorporation v. United States*, 732 F.2d at 377.]

The Fourth Circuit in *Southern Bancorporation* did not hold that the purchaser of a business must evaluate separately, or assign a portion of the aggregate purchase price to, any of the individual assets at the time of acquisition. The language quoted above is merely the Fourth Circuit's initial step in holding that the taxpayer in the case before the court failed to prove that it paid an amount exceeding face value for the loans. Certainly an intention to pay, or the allocation of, a specific price for the loans at the time of the acquisition would be persuasive evidence to establish the taxpayer's basis. Finding such evidence absent, the court nevertheless considered whether the taxpayer had proved that the fair market value of the loans exceeded their face amounts on the date of purchase and concluded that the taxpayer had not met its burden of proof. *Southern Bancorporation v. United States*, 732 F.2d at 378.

We recognize that the Fourth Circuit prefaced its inquiry into market value with "Even if we assume, *arguendo*, that the bases of the portfolios should be fair market value" (732 F.2d at 378), and that the language quoted from *Better Beverages, Inc. v. United States*, 619 F.2d 424 (5th Cir. 1980), seemingly precludes the post-acquisition allocation of a portion of the purchase price to an asset unless contemplated at the time of the acquisition. The court in *Better Beverages* emphasized, however, that the case before it concerned the allocation of basis to a covenant not to compete. The court therefore held

the taxpayer to a higher standard of proof than would be necessary to establish the bases of most other assets.

> As to most physical assets and many intangibles, such as copyrights or patents, there may be a sufficient correlation between the value of the item to the buyer and its value to the seller to render evidence of the former probative of the latter, and therefore, of cost. * * *
>
> Covenants not to compete are not of this ilk, however. First, they generally are not susceptible to an abstract fair market valuation, because they are not independently traded and, thus, have little or no cognizable value apart from the context of a seller's conveyance of his business. More importantly, unlike the simple transfer of ownership in a conventional sale, the interest relinquished by the seller in executing a covenant not to compete is not parallel to that sought or received by the buyer. The value of such a covenant to a purchaser like Better Beverages, derives from the projected degree of increased profitability and likelihood of survival of its new enterprise attributable to the insulation of that enterprise, afforded by the covenant, from the deleterious competitive force that the seller could present. Value to the seller, on the other hand, is the measure of his foregoing the opportunity to re-enter a particular market for a given period. Consequently, because they are functions of totally independent sets of considerations, the respective values of the covenant to the buyer and seller are simply unrelated. For example, while a buyer may place great significance on the covenant as a protective device, a seller, who either does not desire to re-enter the market or who is independently foreclosed from re-entry, may place virtually no value on the same covenant. Accordingly, evidence and allegations of the value of a covenant to its purchaser, not communicated to the seller during negotiations or at the time of sale, simply cannot alone predict the countervailing value to the seller or answer the more fundamental question of actual cost basis.
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> [619 F.2d at 429. Fn. ref. omitted.]

A covenant not to compete is not an asset of the seller's business, but an independent undertaking of the seller. Consistent with *Better Beverages*, the courts generally require a purchaser to prove that the parties intended, at the time of the acquisition, to allocate a specific portion of the purchase price to the covenant. Mere proof that the covenant possessed value typically is insufficient to establish the purchaser's basis therein. See, e.g., *Theophelis v. United States*, 751 F.2d 165 (6th Cir. 1984); *Markham & Brown, Inc. v. United States*, 648 F.2d 1043 (5th Cir. 1981); *Peterson Machine Tool, Inc. v. Commissioner*, 79 T.C. 72 (1981), affd. in an unreported opinion (10th Cir. 1984), 54 AFTR 2d 84–5139, 84–2 USTC par. 9885); *Major v. Commissioner*, 76 T.C. 239 (1981).

Commercial exigencies often prevent the purchaser from separately evaluating each asset before the acquisition.[2] Moreover, although tax reporting often compels an apportionment of the aggregate purchase price among the individual assets, the purchaser of an operating business is buying a unitary economic enterprise, not a basket of discrete assets. The information yielded by an item-by-item appraisal may thus be of little use to a purchaser, like petitioner, who bases his investment decisions upon earnings or return on investment rather than underlying asset values. The seller may be indifferent to individual asset allocations even for tax purposes where, as in the current case, a complete liquidation is to follow the sale. (See sec. 337.)

Specific allocation in the purchase agreement or in negotiations leading thereto may be the best evidence of the purchaser's basis in each asset. Where such evidence is not present, however, we must allocate the aggregate purchase price among the individual assets based upon the evidence available to us. In numerous cases similar to the one now before us, this Court and others have utilized the relative fair market values of the acquired assets in performing this task. See, e.g., *Laird v. United States*, 556 F.2d 1224 (5th Cir. 1977); *KFOX, Inc. v. United States*, 206 Ct. Cl. 143, 510 F.2d 1365 (1975); *Computing & Software, Inc. v. Commissioner*, 64 T.C. 223 (1975); *First Pennsylvania Banking & Trust Co. v. Commissioner*, 56 T.C. 677 (1971); *Victor Meat Co. v. Commissioner*, 52 T.C. 929 (1969). See also sec. 1.167(a)-5, Income Tax Regs. (providing that where the taxpayer acquires a combination of depreciable and nondepreciable property for a lump sum, the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of the acquisition bears to the value of the entire property at that time). The burden of proving the value of each

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[2] When asked at trial why petitioner did not perform a detailed analysis of the assets and liabilities of Old Athens before the acquisition, petitioner's officer in charge of acquisitions replied:

"you have to understand how the market place works. Whether it's the Lindners connected with Athens National Bank, or most any other bank that we are wanting acquire, it's typically a competitive, or potentially a competitive situation, and there's just no way that a bank, typically, is willing to let you go in and spend all of that time and have all of that involvement and disruption in the bank, before you commit to what it is you're willing to pay. If we insisted on that kind of up-front involvement, we'd never make any deals. We'd never make any acquisitions."

asset of course rests upon petitioner. *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 683–684 (5th Cir. 1971).

Loan Premium

We conclude that petitioner has not satisfied its burden of proof with respect to the loans acquired by New Athens. We thus reject petitioner's attempt to increase the bases of the loans by use of the loan-spreading process.

According to petitioner, both the methodology utilized and the results obtained are consistent with *Commissioner v. Seaboard Finance Co.*, 367 F.2d 646 (9th Cir. 1966), affg. a Memorandum Opinion of this Court. In *Seaboard Finance*, the Ninth Circuit Court of Appeals affirmed this Court's allowing the taxpayer to allocate a portion of the acquisition prices of several loan companies to loan premiums.

Although the taxpayer in *Seaboard Finance*, like petitioner, determined the amount of the premiums by loan spreading, *Seaboard Finance* is readily distinguishable from the present case. The taxpayer in *Seaboard Finance* performed the spreading process in calculating the values of the loans to be purchased and used the values so calculated in formulating its offering prices to the sellers. Moreover, the uncontradicted evidence indicated that, at the times of purchase, the loans were worth the amounts determined by the taxpayer. See *Seaboard Finance Co. v. Commissioner*, T.C. Memo. 1964–253, 23 T.C.M. 1512 at 1516–1517, 1534, 33 P-H Memo T.C. par. 64,253, at 64–1660, 64–1679. The taxpayer in *Seaboard Finance* thus established that it paid for the loans amounts exceeding their face values.

In the present case, by contrast, petitioner has not shown that it paid more than book value for the Old Athens loans. Although petitioner did consider the loans in evaluating the proposed acquisition of Old Athens, petitioner did not utilize the loan "values" as determined by Coopers in negotiating an acquisition price with Old Athens. The loan spreading performed by Coopers was merely a post-acquisition means of allocating the purchase price among the acquired assets. As discussed above, pre-acquisition allocation is evidential but not essential. But here, petitioner has not otherwise proved that the fair market value of the loans exceeded their book value on the date of the acquisition. For financial accounting purposes,

petitioner attempted to restate the assets acquired from Old Athens at fair market values. In so doing, petitioner reduced the aggregate carrying value of the loans by $389,000. The stated purpose of this adjustment was "to adjust the interest rates on loans to current rates charged by the bank." Indeed, the evidence indicates that the yields on the loans were generally lower than market rates for similar loans on the date of the acquisition and thus that the loans were actually worth *less* than face. Grover testified that, at the time of the acquisition, the loans could not have been sold "for their premium values." See *Southern Bancorporation v. United States*, 732 F.2d 374, 378 (4th Cir. 1984).

Petitioner attempts to prove that the loans possessed value exceeding the face amounts by linking the deposits and loans of Old Athens. Even if the yields on the loans were below market, according to petitioner, the loans were worth more than face because they were funded with deposits having a still lower effective cost. Petitioner points out that one of the criteria utilized in spreading the loans was whether the borrower maintained a deposit account with Old Athens.

Petitioner's argument is unsupported by the evidence. Although the borrower's deposit or other relationship with Old Athens was a factor used in spreading the loans, petitioner's assumption that deposits were economically or contractually tied to loans is pure speculation. There is no evidence that Old Athens' loan customers in fact had deposits with the bank, much less that each customer maintained loans and deposits with relatively equal balances and maturities. Presumably Old Athens could have transferred its deposits and its loans to different purchasers or in separate transactions. The acquirer of the deposits might be willing to assume the liability in exchange for an amount of cash less than the deposit balance, if he could deploy the funds at rates exceeding the costs of maintaining the deposits. The acquirer of the loans, on the other hand, generally would be willing to pay more than face amount only if the stated yield exceeded the market rate on similar loans. We do not doubt that deposits are the source of loans or that banks manage the two relationships in tandem.

We merely reject petitioner's attempt to attribute to loans the value inherent in deposits.[3]

Core Deposits

We now turn to petitioner's argument raised in its amended petition that a portion of the acquisition prices of both Old Athens and First Citizens is allocable to a core deposit intangible. According to petitioner, it has established a value for the core deposits separate from goodwill and any other nondepreciable intangible asset and has determined the useful life of the intangible with reasonable accuracy. Petitioner thus contends that it has satisfied the requirements prescribed in section 1.167(a)–3, Income Tax Regs., *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973); and *L.A. Central Animal Hospital v. Commissioner*, 68 T.C. 269 (1977)), for depreciation of an intangible asset.

Respondent admits that the core deposits acquired by petitioner possessed value. He argues, however, that the value attributable to the core deposit base of a bank constitutes or is inseparable from goodwill or other nondepreciable intangibles and that the depositor base is "self-regenerative" and thus does not possess a determinable useful life. Respondent further asserts that petitioner has failed to quantify accurately the value of the core deposits acquired from Old Athens and First Citizens. Finally, respondent contends that petitioner has not established a proper method for depreciating the deposits.

We agree with respondent's final contention, although not for the reasons suggested by respondent. The reports prepared by PM were the only evidence submitted by petitioner to calculate depreciation with respect to the core deposits, and those reports relied upon events occurring after the years in issue. Therefore, even if we were to hold that petitioner has established its bases in the deposits and that the core deposit intangible is a depreciable asset, we could not allow petitioner depreciation deductions on the record before us.

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[3] In commenting upon petitioner's loan spreading procedure, one of petitioner's expert witnesses testified: "I thought the methodology was definitely reasonable; that the results seemed to be accurate based upon the methodology utilized; and that the results of the entire transaction were certainly reasonable." Like all of the evidence cited by petitioner in support of its loan premium theory, the above testimony does not indicate that the loans, separate from the deposits, possessed value exceeding the face amounts.

A taxpayer may establish the useful life of an asset for depreciation based upon his own experience with similar property or, if his own experience is inadequate, based upon the general experience in the industry. Sec. 1.167(a)–1(b), Income Tax Regs. The taxpayer need only determine a "reasonable approximation" for depreciation; absolute certainty is not required. *Burnet v. Niagara Falls Brewing Co.*, 282 U.S. 648 (1931); *Super Food Services, Inc. v. United States*, 416 F.2d 1236 (7th Cir. 1969); *Spartanburg Terminal Co. v. Commissioner*, 66 T.C. 916 (1976). As the Supreme Court noted in *Massey Motors, Inc. v. United States*, 364 U.S. 92, 105 (1960): "prediction is the very essence of depreciation accounting."

This Court and others have repeatedly stated, however, that the determination of the useful life of an asset and the other estimates utilized in computing depreciation must be based upon facts existing as of the close of the taxable year in issue. See, e.g., *Western Terminal Co. v. United States*, 412 F.2d 826 (9th Cir. 1969); *Commissioner v. Cleveland Adolph M.R. Corp.*, 160 F.2d 1012 (6th Cir. 1947); *Roy H. Park Broadcasting v. Commissioner*, 78 T.C. 1093 (1982); *Airport Building Development Corp. v. Commissioner*, 58 T.C. 538 (1972); *Westinghouse Broadcasting Co. v. Commissioner*, 36 T.C. 912 (1961), affd. 309 F.2d 279 (3d Cir. 1962). Thus, in determining the useful life of the taxpayer's freight cars in *Southern Pacific Transportation Co. v. Commissioner*, 75 T.C. 497, 668 (1980), we refused to consider statistical studies of experts that utilized facts occurring after the years in issue:

> Indeed, this evidence is singularly unsuitable for the purpose of proving useful life in this case for the reason that * * * [the taxpayer's expert] admittedly employed data in his study from * * * years * * * [subsequent to the years in issue]. * * * [The expert] testified that, without the data from these years, he would not have been able to reach any specific conclusions as to useful life of the postwar cars at the end of * * * [the years in issue]. Since the information relied on by * * * [the expert] in making his analysis was not available for consideration at the end of the years at issue, his conclusions cannot be relied on herein. The * * * statistics which * * * [the taxpayer's expert] employed were obviously not available to petitioner for the making of its contemporaneous determination of useful life. [Fn. ref. omitted.]

See also *Southern Pacific Transportation Co. v. Commissioner*, 75 T.C. at 707–708 (similar conclusion with respect to diesel

locomotives).[4] Indeed, the regulations indicate that depreciation must be computed and its validity judged prospectively, not retrospectively:

> The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. It is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed. [Sec. 1.167(b)-0(a), Income Tax Regs.]

Petitioner argues that the acquired core deposits should be depreciated in accordance with the amortization schedules prepared by PM. Both of those schedules, however, were based upon, and their accuracy depended upon, petitioner's actual experience with the acquired accounts in years subsequent to the years in issue. In preparing the schedule for Old Athens, PM examined sample accounts 2 to 6 years after the acquisition, all of which were subsequent to the years for which petitioner now claims depreciation. Although PM did examine the behavior of First Citizens' accounts during 1974 and 1975, the 2 years in issue, the data upon which PM based its computations also included events occurring during 1976 and 1977. PM stated in the report for First Citizens that the accuracy of the calculations therein was "conditional on the sample of accounts selected." Cf. *Southern Pacific Transportation Co. v. Commissioner*, 75 T.C. at 668, quoted *supra*.

The Fourth Circuit articulated the rationale behind the prohibition against using hindsight evidence to compute depreciation as follows:

> taxation is made too uncertain and controversies too long extended if what is claimed or allowable as of the time the return is filed is made subject to revision and adjustment by the Commissioner or by the taxpayer in the light of events occurring several years later. What depreciation is allowable, therefore, is determinable on the basis of facts known or reasonably predictable when the return is filed and may not be made dependent upon * * * [events] actually realized in subsequent years. [*Johnson v. Commis-*

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[4] In *Southern Pacific Transportation Co. v. Commissioner*, 75 T.C. 497 (1980), the taxpayer attempted to establish a shorter useful life than that claimed on its tax returns for the years in issue. We therefore required the taxpayer to show a "clear and convincing basis" for the change. 75 T.C. at 661–664. See secs. 1.167(a)–1(b), 1.167(b)–0(a), Income Tax Regs. Our holding the taxpayer to a higher standard of proof than the "reasonable approximation" normally required to establish useful life was independent from our refusal to consider facts not existing at the end of the years in issue.

sioner, 302 F.2d 86, 88 (4th Cir. 1962), affg. a Memorandum Opinion of this Court.]

Petitioner's proposed method of depreciation is similar to that of the taxpayers in *Manhattan Co. of Virginia, Inc. v. Commissioner*, 50 T.C. 78 (1968); *Holden Fuel Oil Co. v. Commissioner*, T.C. Memo. 1972–45, affd. 479 F.2d 613 (6th Cir. 1973); and *Midlantic National Bank v. Commissioner*, T.C. Memo. 1983–581. In each of those cases, we rejected the taxpayer's computation of depreciation of a customer list based upon the number of customers actually lost each year. The method proposed by petitioner for the years in issue is different only in that it is based upon a sample of the deposit accounts actually lost. We see no reason to distinguish between "total" hindsight and "sample" hindsight.

We allowed the taxpayers in the above cases to compute depreciation under alternative methods. In each of those cases, however, there existed evidence of prior experience of the taxpayer or the industry upon which we could base our determinations. Petitioner, in the present case, did present expert testimony on the reasonableness and accuracy of PM's reports and the general nature of core deposits. We cannot find, however, any specific evidence in the record of the experience of petitioner or of any other bank as of the years in issue upon which we might compute depreciation on the core deposits. With the exception of the reports prepared by PM, petitioner has presented no evidence whatsoever of the useful life of, or the general reasonableness of the depreciation claimed with respect to, the acquired deposit accounts. It is one thing to utilize hindsight evidence to *support* a prospective computation, but quite another to base depreciation solely upon subsequent events. Compare *Super Food Services, Inc. v. United States*, 416 F.2d 1236, 1240 (7th Cir. 1969) ("[We] find no objection to taxpayer's adducing evidence of its experience with contract terminations subsequent to the * * * [year in issue] for the purpose of *corroborating* the estimate of useful life of the contracts *based on * * * [prior] experience*"; emphasis added.) with *Southern Pacific Transportation Co. v. Commissioner*, 75 T.C. at 669.

Issue 2: "Second Tier" Allocations

The final question before us is the validity of petitioner's "second tier" allocations of the acquisition prices. Petitioner argues that it has established fair market values for each asset acquired from Old Athens and First Citizens and that, for each acquisition, the excess of the consideration paid over the aggregate fair market value should be allocated among the assets (other than cash and cash equivalents) based upon relative market values. Respondent asserts that any excess of the purchase price over the aggregate value of the tangible assets is allocable to goodwill and other nondepreciable intangibles under the "residual method" of valuation. We hold for respondent on this issue.

Both acquisitions were transactions between unrelated parties, and therefore the purchase prices are the best evidence of the fair market values of the acquired assets. *Florida Publishing Co. v. Commissioner*, 64 T.C. 269, 279–280 (1975), affd. without published opinion 552 F.2d 367 (5th Cir. 1977). Moreover, the parties do not dispute the values of any of the tangible assets acquired, except the Old Athens loans.[5] Since petitioner has not proven that the value of those loans exceeded their face amounts, this case represents the paradigm for application of the residual method. See *Solitron Devices, Inc. v. Commissioner*, 80 T.C. 1, 20–22 (1983), affd. without published opinion 744 F.2d 95 (11th Cir. 1984); *R.M. Smith, Inc. v. Commissioner*, 69 T.C. 317, 320 (1977), affd. 591 F.2d 248 (3d Cir. 1979); *Jack Daniel Distillery v. United States*, 180 Ct. Cl. 308, 379 F.2d 569, 579 (Ct. Cl. 1967). "Under such method, the value of the intangible assets equals the difference between the total purchase price and the value of the tangible assets." *Solitron Devices, Inc. v. Commissioner*, 80 T.C. at 22.[6]

Petitioner argues that under the opinion of the Third Circuit Court of Appeals in *R.M. Smith, Inc. v. Commissioner*, 591 F.2d 248 (3d Cir. 1979), affg. 69 T.C. 317 (1977), we should not utilize

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[5] We recognize that loans are technically intangible assets. For clarity of discussion, however, we shall refer to all of the assets carried in the financial records of Old Athens and First Citizens as tangible assets.

[6] Because we have held that petitioner is not entitled, on the record before us, to depreciate any core deposit intangible acquired in the transactions, we need not determine whether core deposits possess value separate from goodwill and other nondepreciable intangible assets or, if so, the value of the deposits for the purpose of applying the residual method. Core deposits, like goodwill, will constitute a portion of the residual after subtraction of the tangible asset values.

the residual method to value the nondepreciable intangibles in the present case. The Third Circuit in *R.M. Smith* recognized that a determination under the residual method is not conclusive of the value of the intangible assets. Although the purchase price is presumed to represent the fair market value of the acquired assets, either party may introduce evidence to rebut that presumption and thereby change the calculated residual value.

> As pointed out earlier, the theoretical underpinning of the residual value method is that the total price paid for the stock equals the sum of the fair market values of all of the underlying assets. Although this is a sound principle in economic theory, in reality it has its shortcomings. Specifically, it fails to take into account the common situation when one party to the transaction achieves a bargain. If the purchaser of the stock obtains a "good deal," then the residual value method would undervalue the goodwill. If, on the other hand, the price paid is too high, then the computation will result in a correspondingly inflated goodwill figure. This problem does not require rejection of the residual value method—price paid *is* strongly probative, albeit not conclusive, of fair market value. However, it does suggest that the court consider evidence which would require alterations in the figure or abandonment of the formula altogether.
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> * * * the residual value method is an appropriate means for deriving the value of intangible assets as long as the total price paid and the values of all other assets are known. The resultant figure, however, is not to be deemed conclusive proof of the unknown value. Evidence suggesting that a fair deal was not reached should be permitted. When appropriate, adjustments should be made in the value assigned to the intangible assets, or a different basis for deriving the figure should be substituted.
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> [591 F.2d at 252–253.]

In the present case, however, petitioner has not proven that it paid more than the aggregate value of the various assets for either Old Athens or First Citizens.

Petitioner's only evidence on this point is testimony that the profit from the Cincinnati loan and lease transactions produced abnormally high earnings for Old Athens before the acquisition; petitioner thus implies that petitioner paid more for the bank than the true value of its underlying assets. We cannot draw that inference in light of the history of the negotiations and preclosing examinations.

Petitioner knew and intended from the outset that New Athens would not continue the Cincinnati transactions (other

than retaining the existing leases). The merger agreement required that the Cincinnati borrowers pay off their loans before consummation of the transaction. Both Grover and petitioner welcomed the termination of the Cincinnati dealings, in light of the expectation that additional funds could be deployed very profitably in the Athens area.

Petitioner's obligations under the merger agreement were contingent upon there being no adverse change in the financial position, business, or aggregate net assets of Old Athens from June 30, 1973, until the date of the merger. Petitioner's officer in charge of acquisitions testified that the purpose of this clause was to allow petitioner to avoid closing the transaction "if the financial condition of the bank, at the time of closing is materially different from what had been represented to us in the various documents and what we had anticipated getting." Coopers began gathering data for the purpose of assigning values to the acquired assets in February or March of 1974; petitioner performed a preclosing examination of Old Athens before consummation of the merger on September 13, 1974; and yet petitioner did not attempt to avoid or change the terms of the transaction. We must therefore conclude that, on the effective date of the merger, petitioner believed it was receiving its money's worth in the acquisition. Coopers completed the allocation of the purchase price only a few months later, and nothing indicates that petitioner's expectations changed in that short time.[7]

We finally note that, in 1975 and 1976, the average amount reported by New Athens as "interest and fees on loans" exceeded the amounts reported by Old Athens in each of the 4 years prior to the acquisition and that Lindner's representative initially proposed a cash price of $13 million, $3 million more than ultimately agreed upon.

Petitioner does not assert that it made a bad bargain in the acquisition of First Citizens and such an argument is not supported by the evidence. First Citizens possessed no qualified management and had experienced problems with its loans. Yet petitioner was well aware of these facts and

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[7] Petitioner's officer testified that "we thought it was a fair price at the time [of the acquisition]" but that "I'm sure that two or three years after the transaction, we would have said, 'Gee, we wouldn't have paid that much for that bank.' " It is value at the time of the acquisition and not 2 or 3 years later than is relevant for our decision.

undoubtedly adjusted its offering price accordingly; the purchase agreement even provided that the ultimate purchase price depended upon the collectibility of problem loans.

Petitioner argues that under *Victor Meat Co. v. Commissioner*, 52 T.C. 929 (1969); *United States v. Cornish*, 348 F.2d 175 (9th Cir. 1965); sec. 1.167(a)-5, Income Tax Regs.; Rev. Rul. 69-539, 1969-2 C.B. 141; and Rev. Rul. 77-456, 1977-2 C.B. 102, the aggregate purchase prices should be allocated among all the acquired assets in proportion to their fair market values. The method proposed by petitioner would result in an allocation different from our determination under the residual method, however, only if the aggregate fair market value of the assets received from Old Athens and First Citizens were not equal to the respective acquisition prices. Petitioner apparently realizes this plain fact in arguing that the cited authorities reflect "the basic tax law principle that a taxpayer shall be allowed as a basis for depreciation the actual cost of an asset, *even if that cost exceeds fair market value.*" (Emphasis added.) But a taxpayer who pays a lump-sum amount for a number of assets may not attribute the cost basis of nondepreciable assets to that of depreciable assets. Sec. 1.167(a)-5, Income Tax Regs. Each of the authorities cited by petitioner thus presumes that the fair market value of each asset is accurately determined before performing the allocation based on relative fair market values. In *Victor Meat Co.*, for example, the parties stipulated the fair market value of every asset acquired. Allocation was necessary only because the sum of the individual asset values did not equal the total purchase price.

Just as petitioner failed to prove that it paid more than fair market value for the assets of Old Athens and First Citizens, petitioner has not demonstrated that it accurately determined the value of each asset acquired.

Petitioner asserts that Coopers properly determined that the value of the "goodwill and other intangibles" acquired from Old Athens was $244,059 and that First Citizens possessed no goodwill. Both calculations were based upon the "formula" or "excess earnings" method of valuing goodwill, a method petitioner urges that we utilize instead of the residual method. According to petitioner, these calculations conformed to the process prescribed in Rev. Rul. 68-609, 1968-2 C.B. 327.

We note, initially, the difficult and uncertain assumptions demanded by such a computation of intangible value based upon the capitalization of excess earnings. Determination of the "normal" earnings of a business, the "average" return on the tangible assets, and the "appropriate" capitalization rate is a highly subjective task. Indeed, the primary virtue of the residual method is obtaining a more accurate valuation of the acquired intangibles without making speculative assumptions and engaging in unnecessarily complex computations, where the total purchase price and the values of the tangible assets are known or ascertainable.

Admittedly, we do not always have the luxury of using the residual method of valuation. See *Concord Control, Inc. v. Commissioner*, 78 T.C. 742 (1982) (formula method utilized where value of tangible assets not reasonably ascertainable).[8] As discussed above, however, use of the residual method is proper in the present case, and we would reject Coopers' determinations under the formula method on that basis alone.

We have nevertheless considered Coopers' determinations under the formula method and found Coopers' computations inadequate. The premise of the formula method is that goodwill and other intangibles often manifest themselves through earnings in excess of the return on *tangible* assets. See, e.g., *Concord Control, Inc. v. Commissioner, supra*. Coopers instead computed the goodwill of Old Athens and First Citizens based upon earnings in excess of the average *total* return for the industry, not only the return on tangibles.[9] We would expect these two measures of excess earnings to be relatively equivalent only if goodwill and other unrecorded intangibles were rare in the industry. If, on the other hand, firms in the industry typically possessed goodwill or other intangible asset value, the average industry earnings would include some return on those intangible assets. Comparing the earnings of an individual firm like Old Athens or First Citizens with the industry average would therefore understate the value of the firm's intangibles. We thus reject petitioner's

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[8] We were similarly unable to utilize the residual method in *Seaboard Automotive, Inc. v. Commissioner*, T.C. Memo. 1981-392 (value of purchased assets exceeded purchase price), and in *Sanders v. Commissioner*, T.C. Memo. 1973-75 (gratuitous transfer of goodwill), cited by petitioner.

[9] Rev. Rul. 68-609, 1968-2 C.B. 327, 328, upon which petitioner relies, provides: "The percentage of return on the average annual value of the *tangible* assets used should be the percentage prevailing in the industry involved at the date of valuation * * *" (Emphasis supplied.)

repeated assertion that "there is no goodwill unless there is also an expectancy of continuing excess earnings capacity," in that petitioner refers to excess over the industry average *total* return. None of the cases cited by petitioner so defines excess earnings. See *VGS Corp. v. Commissioner*, 68 T.C. 563 (1977); *Wilmot Fleming Engineering Co. v. Commissioner*, 65 T.C. 847 (1976); *Proctor v. Commissioner*, T.C. Memo. 1981–436.

In *Ballantine v. Commissioner*, 46 T.C. 272, 278 (1966), we determined that an unprofitable business possessed goodwill:

> Respondent argues that because of the poor earnings record of petitioners with the * * * [business] there was no goodwill attached to the business. While the value of goodwill is often sought from consideration of excess earnings, and goodwill is often used in that context, certainly goodwill may arise from something other than excess earnings. * * * It has been said that goodwill is nothing more than the probability that the old customers will resort to the old place. The assets purchased by the buyers in this case were acquired primarily to produce such a result. We doubt that the value of the goodwill, trade name, and circulation lists of the * * * [business] was reduced by the fact that the * * * [business] lost money while petitioners operated it or that the losses resulted from a lack of value in those assets. [Citations omitted.]

Excess earnings, however defined, are thus merely indicia of goodwill. As petitioner asserts, we have stated:

> goodwill exists where there is an "expectancy of both continuing excess earning capacity and also of competitive advantage or continued patronage." *Wilmot Fleming Engineering Co. v. Commissioner*, 65 T.C. 847, 861 (1976). [*Midlantic National Bank v. Commissioner*, T.C. Memo. 1983–581, 46 T.C.M. 1464, at 1470, 52 P-H Memo T.C. par. 83,581, at 83–2374. Fn. ref. omitted.]

It does not necessarily follow, however, that goodwill *cannot* be present in the absence of excess earnings capacity. Cf. *Concord Control, Inc. v. Commissioner*, 615 F.2d 1153 (6th Cir. 1980), affg. a Memorandum Opinion of this Court; *Miller v. Commissioner*, 39 T.C. 940 (1963) (holding that excess earnings alone not sufficient to establish goodwill), affd. 333 F.2d 400 (8th Cir. 1964). A business might possess substantial goodwill or other intangible value and yet be confronted with a substandard tangible asset base or abnormally high operating costs and thus not realize earnings in excess of a normal return on tangible assets.

The Supreme Court long ago defined goodwill as—

the advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessity, or even from ancient partialities or prejudices. [*Metropolitan Bank v. St. Louis Dispatch Co.*, 149 U.S. 436, 446 (1893).]

"[T]he essence of goodwill is the expectancy of continued patronage, for whatever reason." *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962), affg. 35 T.C. 720 (1961). See also *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677 (5th Cir. 1971), and cases cited therein.

Going-concern value, also a nondepreciable intangible, is "the additional element of value which attaches to property by reason of its existence as an integral part of a going concern." *VGS Corp. v. Commissioner*, 68 T.C. at 591. It is manifested by "the ability of the acquired business to continue generating sales without interruption during and after acquisition." *Solitron Devices, Inc. v. Commissioner*, 80 T.C. 1, 20 (1983), affd. without published opinion 744 F.2d 95 (11th Cir. 1984).[10]

Examining Old Athens in light of these characteristics confirms our valuation under the residual method. Old Athens was by far the largest bank in Athens County and New Athens continued to use the undoubtedly familiar name of "Athens National Bank." In Grover, the bank possessed an experienced chief executive who was visible and active in the community and had acquired most of the local business accounts. The record indicates that both Grover and petitioner intended to utilize Grover's banking experience and stature in the community to ensure that the old customers returned to the old place of business after the acquisition. It is of little consequence that Grover did not sign an employment contract with New Athens. The clause in the merger agreement prohibiting Grover from working for United Dairy indicates the parties' intention that

[10]Petitioner presented at trial reports in which Coopers calculated the going-concern value of Old Athens at $314,000 and of First Citizens at $94,000 as of the acquisition dates. Because both goodwill and going-concern value are nondepreciable, and because we have properly utilized the residual method herein, we need not separately examine going-concern value. See *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677 (5th Cir. 1971); *Computing & Software, Inc. v. Commissioner*, 64 T.C 223 (1975); cf. *supra* note 6.

Grover remain at New Athens. Finally, almost all of the other employees remained with New Athens as well.

Turning to First Citizens, we recognize the absence of an experienced executive, the small market share controlled by the bank, and the other factors indicating that the goodwill and going-concern value of First Citizens was lower than that of Old Athens. First Citizens was an operating and profitable bank, however, and Barnitz continued to use the name "First Citizens" and to employ its personnel. In any event, the value of the core deposits of First Citizens, as determined by PM and asserted by petitioner, far exceeds the excess over book value paid for First Citizens.[11]

Decision will be entered under Rule 155.[12]

NATIONAL SAVINGS LIFE INSURANCE COMPANY, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 22379–80. Filed March 28, 1985.

Petitioner, a life insurance company under subch. L, I.R.C. 1954, acquired life insurance reserves from Progressive, also a life insurance company under subch. L, I.R.C. 1954, pursuant to a statutory merger. Petitioner had elected under sec. 818(c), I.R.C. 1954, to revalue its preliminary term reserves, while Progressive had not so elected. *Held*, sec. 381, I.R.C. 1954, does not require petitioner to add the acquired reserves to its sec. 810, I.R.C. 1954, opening balance in the revalued amount; rather, petitioner must include the unrevalued dollar balance of the acquired reserves in its opening balance.

Petitioner held reserves with respect to certain life insurance policies containing both term insurance and permanent insurance components. *Held*, for purposes of the sec. 818(c)(2), I.R.C. 1954, reserve revaluation, petitioner must segregate its contracts into their facially discernible components of term and

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[11] See *supra* note 6.

[12] In the statutory notice of deficiency, respondent denied all deductions claimed by petitioner to the extent that the deductions were based upon costs in excess of the book values of the acquired assets. In his briefs, respondent apparently acquiesces, with respect to most assets, in petitioner's use of cost bases equal to fair market values as of the acquisition dates. Because several of the assets acquired by petitioner had fair market values *below* their book values, allowing petitioner cost bases equal to fair market values does not necessarily reduce the deficiencies determined by respondent. Because of this uncertainty, we are directing a Rule 155 computation.

permanent insurance in force during the years in issue, applying sec. 818(c)(2)(A), I.R.C. 1954, only to the permanent components, and sec. 818(c)(2)(B), I.R.C. 1954, only to those facially discernible term components covering a period of more than 15 years at the time of issuance. *Held, further*, that sec. 818(c)(2), I.R.C. 1954, requires a proportional segregation of the reserves based on the reserve that would have been required for the separate components had they been issued as separate policies.

Petitioner issued renewable accident and health insurance policies and properly computed, using the 2-year preliminary term method, a mid-terminal reserve of zero dollars for policies in force for 2 years or less. *Held*, such policies in force for 2 years or less qualify as "guaranteed renewable" under sec. 1.801-3(d), Income Tax Regs. *National States Insurance Co. v. Commissioner*, 81 T.C. 325 (1983), and *United Fire Insurance Co. v. Commissioner*, 81 T.C. 368 (1983), followed.

Carolyn P. Chiechi, Francis M. Gregory, Jr., Joseph F. McKeever III, and *William B. Harman, Jr.*, for the petitioner.
James F. Kearney, for the respondent.

TANNENWALD, *Judge*: Respondent determined the following deficiencies in petitioner's Federal income taxes:

1972	$251,979
1973	127,952
1974	124,309

After agreements between and concessions by the parties, the issues for decision are:

(1) Whether petitioner is required to revalue life insurance reserves acquired in a statutory merger before adding such reserves to its own revalued opening balance of reserves for the year in which the merger took place, and, if so, whether petitioner is entitled to a deduction as an adjustment to reflect the revaluation;

(2) Whether petitioner may utilize the statutory formula appropriate for life insurance other than term insurance in revaluing the life insurance reserves it held with respect to certain contracts for which reserves were computed on a preliminary term basis; and

(3) Whether petitioner's renewable individual accident and health insurance policies that were in force for two years or less as of the end of each of its taxable years 1971, 1972, 1973,

and 1974 are "guaranteed renewable" accident and health insurance policies.[1]

GENERAL FINDINGS OF FACT

The facts as to issues (1) and (3) above have been fully stipulated and are so found. Some of the facts as to the remaining issue have been stipulated and are so found. This reference incorporates the stipulations of facts and attached exhibits.

Petitioner, a Tennessee corporation authorized to do business in nine states as a stock life insurance company, had its principal office at the time it filed its petition in this case in Murfreesboro, Tennessee. Petitioner timely filed its Federal income tax returns for each of the years 1970 through 1974 with the Internal Revenue Service Center in Memphis, Tennessee.

During each of the years in issue, petitioner was a life insurance company, as defined in section 801(a),[2] subject to tax under the provisions of sections 801 through 820 (subchapter L, part I). In 1965, petitioner elected, pursuant to section 818(c), to revalue on the approximate method under section 818(c)(2) its life insurance reserves[3] that were computed on a preliminary term basis.[4] Petitioner was required to file, and did file, with the insurance department of each of the States in which it carried on an insurance business an annual statement prepared as prescribed by the National Association of Insurance Commissioners (NAIC) for insurance companies licensed to write life and accident and health insurance. The annual statement contains information as to petitioner's assets and

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[1] A fourth open issue, dealing with the proper amount of net operating loss carryover from 1970 to the years in issue, will be decided based entirely upon our decision as to the above three issues and the parties' stipulation as to carryovers to 1970.

[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue, and all Rule references are to the Rules of Practice and Procedure of this Court.

[3] Statutory life insurance reserves are required by State law to be held in an amount calculated in a specified manner that assures that such reserves, together with future net valuation premiums and future interest at the assumed rate, will be adequate to cover future death claims and other benefits under such policies. A statutory life insurance reserve with respect to an insurance contract may be defined, prospectively, as the difference, at any point in time, between the present value of future benefits provided under such contract and the present value of future net premiums for such contract. See *infra* note 7.

[4] For a description of the preliminary term method of reserve valuation, see *infra* pp. 516–517.

liabilities as of December 31 of each year and as to its income and expenses for each year.

Issue 1

FINDINGS OF FACT

As of August 19, 1970, Progressive Citizen Life Insurance Co. (Progressive), a stock life insurance company organized in 1964 under the laws of the State of Mississippi, was merged with and into petitioner in a statutory merger meeting the requirements of section 368(a)(1)(A) and to which section 381 was applicable. At the beginning of its taxable year 1970, and prior to its merger as of August 19, 1970, petitioner held life insurance reserves that were computed on a recognized preliminary term basis in the amount of $2,259,827 with respect to life insurance contracts that it had issued and that were in force at that time. As petitioner did not have any liabilities at the beginning of its taxable year 1970 and prior to the merger with respect to the life insurance contracts that Progressive had issued and had in force at the beginning of 1970, petitioner did not hold at the beginning of its taxable year 1970 any life insurance reserves with respect to such contracts of Progressive. As a result of the merger with Progressive, petitioner succeeded to all the rights and obligations of Progressive under each of the insurance contracts that Progressive had issued prior to such merger. Accordingly, after such merger, petitioner issued to each of Progressive's policyholders a "Certificate of Assumption," which informed each such policyholder of petitioner's assumption of Progressive's obligations under such policies.

On August 19, 1970, the date of the merger, Progressive transferred to petitioner the dollar balance, viz $1,184,218, of Progressive's accounts on such date that represented life insurance reserves with respect to life insurance contracts the reserves for which were computed on a recognized preliminary term basis. Following the merger, a report setting forth, inter alia, the assets and liabilities of Progressive as of the date of such merger was filed with the Insurance Department of the State of Mississippi. Such report showed that as of August 19, 1970, immediately prior to the merger, Progressive held life insurance reserves including life insurance reserves computed

on a recognized preliminary term basis. All such life insurance reserves were transferred by Progressive to petitioner in such merger.

Throughout its existence, Progressive was a life insurance company, as defined in section 801(a), and as such was subject to tax under sections 801 through 820 (subchapter L, part I). As of its merger with petitioner, Progressive had made no election under section 818(c) to revalue its life insurance reserves that were computed on a preliminary term basis. On its tax returns for its taxable years ended on or before August 19, 1970, Progressive had taken a deduction under section 809(d)(2) in the total amount of $1,184,218 with respect to the life insurance reserves that were computed on a recognized preliminary term basis and the unrevalued dollar balance of which was transferred to petitioner on August 19, 1970.

On the date of the merger, Progressive and petitioner employed different methods of accounting, within the meaning of section 381(c)(4) and section 1.381(c)(4)–1, Income Tax Regs., with respect to their respective life insurance reserves that were computed on a recognized preliminary term basis. Progressive's method was to account for such reserves without revaluing them under section 818(c), while petitioner's method was to revalue such reserves under section 818(c)(2). Immediately after its merger with Progressive, petitioner held an amount of life insurance reserves computed on a recognized preliminary term basis, excluding the amount of life insurance reserves computed on a preliminary term basis that were transferred to it in the merger, that, when revalued pursuant to petitioner's section 818(c)(2) election, exceeded the amount of life insurance reserves that were held and transferred by Progressive to petitioner in the merger. At the end of its taxable year 1970, petitioner held life insurance reserves that were computed on a recognized preliminary term basis in the amount of $4,402,893 with respect to (1) life insurance contracts that it had issued and that were in force at the end of its taxable year 1970, and (2) life insurance contracts that Progressive had issued and that were if force at the end of petitioner's taxable year 1970 and for which petitioner had assumed liability as of August 19, 1970 as a result of the merger of Progressive into petitioner.

In determining its January 1, 1970 reserves for tax purposes, petitioner revalued under section 818(c)(2) its life insurance reserves that were computed on a recognized preliminary term basis and that it held at the beginning of its taxable year 1970 with respect to life insurance contracts that it had issued and that were in force as of the beginning of its taxable year 1970. Petitioner also took into account the unrevalued dollar balance, viz $1,184,218, of the life insurance reserves with respect to life insurance contracts for which such reserves were computed on a recognized preliminary term basis that were transferred to it by Progressive on the date of the merger. In determining its December 31, 1970 reserves for tax purposes, petitioner revalued under section 818(c)(2) its life insurance reserves that were computed on a recognized preliminary term basis and that it held at the end of its taxable year 1970 with respect to (1) life insurance contracts that it had issued and that were in force at the end of its taxable year 1970, and (2) life insurance contracts that Progressive had issued and that were in force at the end of petitioner's taxable year 1970 and for which petitioner had, as a result of the merger of Progressive into petitioner, assumed liability as of August 19, 1970.

Respondent determined that the dollar balance, viz $1,184,218, of the life insurance reserves with respect to life insurance contracts for which such reserves were computed on a recognized preliminary term basis that were transferred by Progressive to petitioner on August 19, 1970 was required to be revalued by petitioner, under section 818(c)(2), in determining petitioner's January 1, 1970 reserves for tax purposes.[5] Such revaluation resulted in increasing by $904,737 the amount (viz $1,184,218) of the life insurance reserves with respect to life insurance contracts for which such reserves were computed on a recognized preliminary term basis that were transferred by Progressive to petitioner on August 19, 1970. On its tax returns for its taxable years ended on or before August 19, 1970, Progressive had not taken a deduction for the amount of $904,737, which is the amount by which (a)

[5] Respondent's action was based upon a determination that revaluation was the principal method of accounting, which petitioner was required to adopt. See secs. 1.381(c)(4)-(c)(2) and 1.381(c)(4)-1(b)(3)(ii), Income Tax Regs. Solely for the purpose of the instant case, petitioner agrees with that determination. See also *infra* pp. 519-520.

the life insurance reserves that were computed on a recognized preliminary term basis and the dollar balance of which Progressive transferred to petitioner on August 19, 1970, as revalued by respondent under section 818(c)(2) (viz $2,088,955), exceeded (b) the dollar balance (viz $1,184,218) of the life insurance reserves computed on a recognized preliminary term basis which Progressive transferred to petitioner on the date of the merger. In determining peritioner's loss from operations, as defined in section 809(b)(2), for the year 1970, respondent did not make an adjustment pursuant to section 481 in conjunction with his determination that the reserves acquired from Progressive were required to be revalued. As a result, no deduction was allowed under section 809(d)(2) for the above amount of $904,737.

OPINION

The issue for our decision is whether petitioner must, under section 381, add the reserves acquired from Progressive in the August 19, 1970 merger to its own January 1, 1970 reserve balance in the amount of the dollar balance of the acquired reserves ($1,184,218) or in the revalued amount under section 818(c) ($2,088,955). Disposition of this issue is of importance in calculating petitioner's deduction under sections 809(d) and 810(b) for its taxable year 1970, and thus its net operating loss carryovers to the years in issue.

As petitioner was, for the years in issue, a life insurance company within the meaning of section 801(a), the provisions of subchapter L, part I apply to the instant case. One of these provisions, section 809(d)(2), provides that for purposes of determining gain or loss from operations, a life insurance company shall be allowed a deduction for "The net increase in reserves which is required by section 810 to be taken into account for purposes of this paragraph." Section 810(b) explains that "If the sum of the items described in subsection (c) as of the close of the taxable year * * * exceeds the sum of such items as of the beginning of the taxable year, the excess shall be taken into account as a net increase referred to in section 809(d)(2)." The "items described in subsection (c)" include life insurance reserves. Sec. 810(c)(1). Thus, apart from the effect of other section 810(c) items, petitioner is entitled to a deduction for its taxable year 1970 in the amount by which

its reserves as of December 31, 1970 exceed its reserves as of January 1, 1970.

Section 818(c) provides an election whereby life insurance companies can revalue for tax purposes such of their reserves as are computed on a preliminary term basis.[6] State insurance authorities generally permit companies to compute their reserves for State law purposes using either the net level premium method or a preliminary term method. The net level premium method adds constant net premiums[7] to the reserve each year sufficient to maintain adequate statutory reserves. However, because a company incurs high first-year policy acquisition expenses, its gross premium[8] after expenses for first policy years is smaller than its net premium, resulting in a reduction of the company's surplus. To avoid this problem, the various preliminary term methods reduce the early-year net premiums to offset the amount of the acquisition expense, resulting in smaller additions to the reserves than under the net level premium method. For example, under the full preliminary term method, the first-year net premium for a given insurance policy becomes the net premium that would be required for a 1-year term insurance policy issued to the same policyholder. See generally D. Gregg & V. Lucas, Life and Health Insurance Handbook 165 (3d. ed. 1973); G. Lenrow, R. Milo & A Rua, Federal Income Taxation of Insurance Companies 368–369 (3d ed. 1979). Because use of the prelimi-

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[6] For the years in issue, sec. 818(c) provides, in relevant part—

For purposes of this part (other than section 801), at the election of the taxpayer the amount taken into account as life insurance reserves with respect to contracts for which such reserves are computed on a preliminary term basis may be determined on either of the following bases;

(1) EXACT REVALUATION.—As if the reserves for all such contracts had been computed on a net level premium basis (using the same mortality assumptions and interest rates for both the preliminary term basis and the net level premium basis).

(2) APPROXIMATE REVALUATION.—The amount computed without regard to this subsection—

(A) increased by $21 per $1,000 of insurance in force (other than term insurance) under such contracts, less 2.1 percent of reserves under such contracts, and

(B) increased by $5 per $1,000 of term insurance in force under such contracts which at the time of issuance cover a period of more than 15 years, less 0.5 percent of reserves under such contracts.

[7] Net premiums with respect to a life insurance contract (also known as net valuation premiums) are the amounts, determined on the basis of mortality tables and interest assumptions, that are used in the computation of statutory life insurance reserves, i.e., life insurance reserves required by State law. The net premium can be understood as the discounted value, given the mortality and interest assumptions, of the insurance company's obligation to cover the risks insured against. See generally S. Huebner & K. Black, Life Insurance 323–330 (10th ed. 1982).

[8] Gross premiums with respect to a life insurance contract are the premiums actually charged the policyholder for the contract, i.e., that which consumers ordinarily refer to as "premiums."

nary term methods results in smaller reserves than under the net level premium method, however, their use results in decreasing the tax deduction under sections 809(d)(2) and 810(b). The revaluation allowed under section 818(c) increases, for tax purposes, the company's reserves computed using a preliminary term method to a level equal to or approximating such reserves as computed under the net level premium method, thus allowing the electing company both the financial benefits of preliminary term reserve valuation and the tax benefits of net level premium reserve valuation. See H. Rept. 34, 86th Cong., 1st Sess. (1959), 1959–2 C.B. 736, 748; S. Rept. 291, 86th Cong., 1st Sess. (1959), 1959–2 C.B. 770, 792.

A company electing under section 818(c) must revalue its reserve balances both at the beginning and end of the taxable year. Sec. 1.810–2(c)(3), Income Tax Regs. The question in the instant case is by what amount petitioner, a company using a preliminary term method and revaluing its reserves under section 818(c), is required to increase its reserves as of January 1, 1970 to take account of the reserves acquired on August 19, 1970 from Progressive, a company valuing its reserves using a preliminary term method and not revaluing them under section 818(c). As petitioner, in any event, will be required to add the revalued amount to its December 31, 1970 balances (see sec. 1.810–2(c)(3), Income Tax Regs.), the disposition of this issue will affect the amount of petitioner's deduction under sections 809(d)(2) and 810(b).

Section 381(a), providing generally for carryovers in corporate acquisitions, states in relevant part—

> In the case of the acquisition of assets of a corporation by another corporation—
>
> * * * * * * *
>
> (2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D), (F), or (G) of section 368(a)(1),
>
> the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, * * *

Section 381(c)(22) provides specifically for acquisitions involving insurance companies—

If the acquiring corporation is an insurance company taxable under subchapter L, there shall be taken into account (*to the extent proper to carry out the purposes of this section and of subchapter L, and under such regulations as may be prescribed by the Secretary*) the items required to be taken into account for purposes of subchapter L in respect of the distributor or transferor corporation. [Emphasis added.]

The regulations under this provision refer to section 381(c)(4) for cases in which reserves are transferred in the acquisition—

the acquiring corporation shall take into account the reserves described in section 810(c) distributed or transferred to it as of the close of the date of distribution or transfer by the distributor or transferor corporation *in accordance with the provisions of section 381(c)(4) and the regulations thereunder*. [Sec. 1.381(c)(22)-(a), Income Tax Regs. Emphasis added.]

Section 381(c)(4), dealing with methods of accounting for corporate acquisitions, provides—

The acquiring corporation shall use the method of accounting used by the distributor or transferor corporation on the date of distribution or transfer unless different methods were used * * * by a distributor or transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of computing taxable income adopted pursuant to regulations prescribed by the Secretary.

This provision applies to the instant case, through section 381(c)(22), because petitioner and Progressive used different methods of accounting—petitioner had elected to revalue its life insurance reserves computed on a preliminary term basis using the approximate method under section 818(c)(2), while Progressive had made no such election. The regulations set forth a general rule for applying section 381(c)(4) that, at first blush, appears to be dispositive of the issue at bar—

The acquiring corporation shall take into its accounts the *dollar balances* of those accounts of the distributor or transferor corporation representing items of income or deduction which, because of its method of accounting, were not required or permitted to be included or deducted by the distributor or transferor corporation in computing taxable income for taxable years ending on or before the date of distribution or transfer. The acquiring corporation shall similarly take into its accounts the *dollar balances* of those accounts of the distributor or transferor corporation which represent *reserves in respect of which the distributor or transferor corporation has taken a deduction* for taxable years ending on or before the date of distribution or transfer. Items of income and deduction shall have the same

character in the hands of the acquiring corporation as they would have had in the hands of the distributor or transferor corporation or corporations if no distribution or transfer had occurred. [Sec. 1.381(c)(4)–1(a)(1)(ii), Income Tax Regs. Emphasis added.]

Thus, in order to carry out the essential purpose of section 381—i.e., enabling the acquiring corporation to step into the "tax shoes" of the acquired corporation[9]—the regulations, again at first blush, appear to require that petitioner treat the reserves acquired in the merger exactly as Progressive treated such reserves, namely, by adding the *dollar balances* of Progressive's reserves on the date of transfer ($1,184,218) to its opening balance. Accord sec. 1.381(c)(22)–1(a), *supra* (acquiring corporation must "take into account the reserves described in section 810(c) distributed or transferred to it"); see also Rev. Rul. 72–344, 1972–2 C.B. 218. Petitioner does not dispute this conclusion; it parts company with respondent only as to his contention that Progressive's reserves should be revalued as of August 19, 1970, and that the revalued dollar balance ($2,088,955) should be added to its January 1, 1970 reserve balance, resulting in a decrease of $904,737 in its deduction for 1970 under sections 809(d)(2) and 810(b).

The controversy centers around the regulations, promulgated under section 381(c)(4), *supra*, that set forth the method of accounting to be used when different methods were used by the acquiring and transferor corporations. Section 1.381(c)(4)–1(b)(3)(ii), Income Tax Regs., provides that if different methods of accounting are employed on the date of transfer with respect to trades or businesses that are integrated after the date of transfer, "the acquiring corporation shall adopt the principal method of accounting determined under paragraph (c) of this section, or the method of accounting determined in accordance with paragraph (d) of this section, whichever is applicable." The method under paragraph (c) is applicable in any case in which it may be used. Sec.

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[9] The committee reports stated that:

"The new rules enable the successor corporation to step into the "tax shoes" of its predecessor corporation without necessarily conforming to artificial legal requirements which now exist under court-made law. Tax results of reorganizations are thereby made to depend less upon the form of the transaction than upon the economic integration of two or more separate businesses into a unified business enterprise."

H. Rept. 1337, 83d Cong., 2d Sess. 41 (1954); S. Rept. 1622, 83d Cong., 2d Sess. 52 (1954).

1.381(c)(4)–1(d)(1)(i), Income Tax Regs. The parties agree that, under the rule in section 1.381(c)(4)–1(c)(2)(iv), Income Tax Regs., which requires a comparison of the aggregate amounts of the item in question held by the parties using different accounting methods, petitioner's revaluation method constitutes the principal method of accounting. It is regarding the operating rules for use of such method, and their application to section 818(c) situations, that the parties disagree.

Section 1.381(c)(4)–1(c)(1), Income Tax Regs., is the operating rule—

> Whenever this paragraph applies, the increase or decrease in tax resulting from the change from the method of accounting previously used by any of the corporations involved shall be taken into account by the acquiring corporation. The adjustments necessary to reflect such change and such increase or decrease in tax shall be determined and computed in the same manner as if on the date of distribution or transfer each of the several corporations whose method or methods of accounting are required to be changed in accordance with this section had initiated a change in accounting method. In addition, the acquiring corporation shall take into account the portion of such adjustments which is attributable to pre-1954 Code years to the extent not taken into account by any of the other corporations in accordance with the rules provided in section 481(b)(4) and this paragraph. If a principal method of accounting is adopted under this paragraph, it will be unnecessary for the acquiring corporation to renew any election previously made by it or by any distributor or transferor corporation with respect to such principal method of accounting. Also, in such event, the acquiring corporation is bound by any election previously made by it or by any distributor or transferor corporation with respect to such principal method of accounting which is in effect on the date of distribution or transfer to the same extent as though the distribution or transfer had not occurred.

An apparent conflict between section 1.381(c)(4)–1(a)(1)(ii), *supra*, which requires petitioner to reflect the different methods of accounting by adding the dollar balance of the acquired reserves to its own reserves, and section 1.381(c)(4)–1(c)(1), *supra*, which, according to respondent, requires petitioner to reflect the adoption of the principal method of accounting by determining the tax consequences as if Progressive had itself made a section 818(c) election on August 19, 1970, lies at the heart of the dispute between the parties.

Respondent's position is neither clear nor consistent. At times, respondent seems to be arguing that, by virtue of section 1.381(c)(4)–1(c)(1), *supra*, the situation herein should be dealt with as though *Progressive* had made a section 818(c)

election, in which event the "dollar balances" petitioner must take into account under section 1.381(c)(4)–1(a)(1)(ii), *supra*, are the revalued dollar balances ($2,088,955). At other times, respondent seems to be arguing that, because of *petitioner's* election, petitioner was obligated, after taking into its accounts the unrevalued dollar balances of Progressive's reserves pursuant to section 1.381(c)(4)–1(a)(1)(ii), *supra*, to revalue those reserves as of August 19, 1970, pursuant to section 1.381(c)(4)–1(c)(1), *supra*. Under either approach, the revalued amount would, according to respondent, be added to petitioner's January 1, 1970 reserve balances for the purpose of determining petitioner's deduction under sections 809(d)(2) and 810(b). Petitioner, on the other hand, steadfastly maintains that nothing in the applicable statutes and regulations requires that what it describes as the "clear mandate" of section 381 and section 1.381(c)(4)–1(a)(1)(ii), *supra*, not be applied, with the result that only the dollar balance of Progressive's reserves, as computed by Progressive on a preliminary term basis, must be added to petitioner's January 1, 1970 reserves. For the reasons hereinafter stated, we agree with petitioner.

Although respondent does not specifically quote the "as if [the acquired corporation] had initiated a change in accounting method" language contained in section 1.381(c)(4)–1(c)(1), *supra*, such language seems to be the only part of the regulations that might support his position that petitioner must take into account the revalued dollar balances. This is so because if Progressive had made the section 818(c) election on August 19, 1970, it would have been required to revalue its reserves immediately before transferring them to petitioner. See sec. 1.810–2(c)(3), Income Tax Regs. In any event, we think that this language provides no foundation for this position. The language, it appears to us, is derived from and identified with the phrase "initiated by the taxpayer," found in section 481.[10] Such derivation and identification, along with the

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[10] Sec. 481(a) provides—

In computing the taxpayer's taxable income for any taxable year (referred to in this section as the "year of the change")—

(1) if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then

(2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted.

location of the "as if" phrase in the regulation—immediately before an explicit reference to pre-481 (i.e., pre-Code) years—leads us to conclude that that portion of section 1.381(c)(4)–1(c)(1), *supra*, comes into play only after it is determined that section 481 is applicable to a given situation.[11] Because the parties, though arguing strenuously as to the applicability of section 481, appear to agree that there is no section 481 issue should we find for petitioner on the issue of petitioner's opening balance, and because of our conclusion that only the dollar balances of Progressive's reserves, as computed by Progressive, must be added to petitioner's January 1, 1970 reserves, the language in section 1.381(c)(4)–1(c)(1), *supra*, is inapplicable to the instant situation. Having rejected respondent's argument that the "as if" language in the regulations requires that petitioner add the revalued amount to its January 1, 1970 reserves, we turn to respondent's contention that petitioner, after taking over the unrevalued dollar balances, was required to revalue the acquired reserves as of August 19, 1970 and add the revalued reserves to its January 1, 1970 balances.

Respondent bases this contention upon a number of provisions of the regulations. First, the last two sentences of section 1.381(c)(4)–1(c)(1), *supra*, provide that petitioner need not renew (and is in fact bound by) its section 818(c) election in order to adopt revaluation as the principal method of accounting. Second, section 1.810–2(c), Income Tax Regs., which sets forth special rules for determining whether there is a net increase or decrease in a company's section 810(c) items, contains a provision for reserves revalued under a section 818(c) election—

> If a company which computes its life insurance reserves on a preliminary term basis elects to revalue such reserves on a net level premium basis under section 818(c), the sum of such reserves *at the beginning and end of all taxable years* (*including the first taxable year*) for which the election applies

except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer.

[11] See also sec. 1.381(c)(4)–1(a)(1)(ii), Income Tax Regs., which provides—

"The amount of the adjustments necessary to reflect a change in accounting method pursuant to this section, the manner in which they are to be taken into account, and the tax attributable thereto shall be determined and computed under section 481 and the regulations thereunder, *subject to the rules provided in paragraphs (c) and (d) of this section.* [Emphasis added.]"

shall be the sum of such reserves computed on such net level premium basis. [Sec. 1.810–2(c)(3), Income Tax Regs. Emphasis added.]

See also sec. 1.810–2(d), example (5), Income Tax Regs. Third, section 1.818–4(d), Income Tax Regs., requires that an electing company must, for the first taxable year of its election, "revalue all its life insurance reserves held with respect to contracts for which such reserves are computed on a preliminary term basis at the end of such taxable year," and, for all other taxable years, "must revalue all its life insurance reserves held with respect to contracts for which such reserves are computed on a preliminary term basis at the beginning or end of the taxable year." Respondent argues that the net effect of these provisions is to require petitioner to take over the acquired reserves and, as it would with any of its own reserves subject to its section 818(c) election, include the reserves in its January 1, 1970 balances in the revalued amount.

As we see it, there is a significant flaw in respondent's argument. The regulations in question provide generally that an electing company must revalue "*its* life insurance reserves" at both the beginning and end of the year. Sec. 1.810–2(c)(3), *supra* (emphasis added). There appears to be no provision regarding the opening balance for reserves acquired during the year; rather, the regulations provide that the January 1 balance of the company's section 810(c) items "shall be the aggregate of the sums of each of such items at the beginning of the taxable year." Sec. 1.810–2(c)(1), Income tax Regs. Revaluation is required as of the beginning of the year in order to prevent deductions based solely on the section 818(c) revaluation without an actual increase in reserves; revaluing as of January 1 any reserves not actually held by the company on that date is unnecessary to this end, and is thus not required under the regulations. See 1 T. Nash, Federal Taxation of Life Insurance Companies, sec. 12.03, at 12–12, 12–13 (1983); see also *United Life & Accident Insurance Co. v. United States*, 329 F. Supp. 765, 779–780 (D.N.H. 1971) (policies that lapse during the year must be revalued as of the beginning of the year, as they were in existence at that time); Rev. Rul. 70–568, 1970–2 C.B. 140 (to the same effect); cf. Rev. Rul. 75–163, 1975–1 C.B. 189 (company assuming reinsurance obligations during year should add zero to its opening balances). Thus, it is only those reserves actually held by petitioner at the beginning of the

year that must be revalued as of that date under the regulations.[12] In the instant case, petitioner acquired the reserves in question after January 1, 1970; thus, the regulations cited by respondent do not require that they be revalued as of that date.

Respondent also argues that the policy underlying section 381 would be violated if we were to hold that petitioner may add the unrevalued acquired reserves to its January 1, 1970 balance, as petitioner would thus enjoy a deduction to which no one would have been entitled had there been no merger, i.e., the $904,737 deduction. While respondent is correct regarding the fact that petitioner seeks a deduction that neither Progressive nor petitioner could have taken absent the merger, we do not find this fact dispositive.

As noted above, the policy behind section 381 is to allow the successor corporation to replace for tax purposes the acquired corporation, and to elevate the substance of the economic transaction over the particular form chosen by the parties. This policy is intended to be furthered by the regulations, which as discussed above, (1) require the acquiring corporation to "take into account the reserves described in section 810(c) distributed or transferred to it as of the close of the date of distribution or transfer by the distributor or transferor corporation" (sec. 1.381(c)(22)–1(a), *supra*), (2) require the acquiror to take into its accounts the "dollar balances" of the "reserves in respect of which the distributor or transferor corporation has taken a deduction" (sec. 1.381(c)(4)–1(a)(1)(ii), *supra*), and (3)

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[12] We note that sec. 1.818–4(d), Income Tax Regs., relied upon by respondent, speaks only to the issue of which reserves are subject to the revaluation election. Sec. 1.818–4(d)(1), *supra*, provides that, for the taxable year of the election, only those reserves which are computed on a preliminary term basis at the end of the taxable year are subject to the election. Thus, any reserves that are "strengthened," i.e., recomputed for State law purposes on a net level premium basis, during such taxable year are not subject to the election. Sec. 1.818–4(d)(2), *supra*, then, simply states that, for later years, reserves are subject to the election so long as they are computed on a preliminary term basis at the beginning *or* end of the year, so that reserves that are strengthened during such later years are subject to the election. Contrary to respondent's assertion, these provisions do not state as of what time the revaluation is to take place. The phrase "at the beginning or end of the taxable year" modifies "computed," not "held." See *United Life & Accident Ins. Co. v. United States*, 329 F. Supp. 765, 779 (D.N.H. 1971).

In addition, while respondent correctly points out that when a company elects under sec. 818(c), there is no deduction in the year of election or any subsequent year for the amount by which the revalued opening reserve balance exceeds the unrevalued closing balance for the previous year (see sec. 1.810–3(f), example (*1*), Income Tax Regs.), this does not necessarily mean that when a company acquires reserves during the year, it must revalue such reserves as of Jan. 1 and thus be denied any deduction relating to such acquisition.

require that the items of deduction have "the same character in the hands of the acquiring corporation as they would have had in the hands of the distributor or transferor corporation or corporations if no distribution or transfer had occurred" (sec. 1.381(c)(4)-1(a)(1)(ii), *supra*).

In the instant case, Progressive ended its short taxable year 1970 on August 19, and took a deduction under section 809(d)(2) for the increase in its life insurance reserves and other section 810(c) items during the short year. The amount of reserves with respect to which Progressive took this deduction (and the deductions in each prior year in which Progressive added to its reserves to reach this amount) was computed on a preliminary term basis, and was not revalued under section 818(c), as Progressive had not made the election. The concern as to the instant case reflected in section 381 and its regulations is that petitioner, in stepping into Progressive's tax shoes, not be able to step back and pick up any tax benefits that Progressive already enjoyed, but step forward from Progressive's tax position as of August 19, 1970. Thus, on that date, petitioner must add the amount with respect to which Progressive already took its deductions—i.e., the unrevalued dollar balance ($1,184,218)—to its opening balances, and continue its year from there, albeit wearing new shoes.

It is true, as respondent urges, that when petitioner revalues its reserves at the end of 1970, including those acquired in the merger, and performs its section 810 calculation, it will compute an increase in the amount of $904,737 that Progressive could not possibly have sustained in 1970.[13] However, the result sought by respondent is also laden with conceptual problems. Pursuant to the merger, petitioner acquired new reserves in much the same manner as it would be collecting gross premiums under contracts issued during the taxable year. To require that petitioner add the revalued amount to its opening balances would be analogous in substance to requiring that petitioner revalue as of January 1 the reserves computed and held with respect to contracts *newly issued* on August 19, thus denying petitioner the deduction under sections 809(d)(2)

[13] Even if Progressive had elected under sec. 818(c) during 1970, assuming Progressive held *some* reserves on Jan. 1, 1970, the requirement under sec. 1.810-2(c)(3), Income Tax Regs., that an electing company revalue its reserves held at the beginning and at the end of the year assures that Progressive could not have computed this increase.

and 810(b) that was intended for companies incurring just such an increase in reserves.

The regulatory scheme under section 381, as we read it, is the shoehorn used to fit companies in petitioner's position as smoothly as possible into the acquired corporation's tax shoes and between two seemingly absurd results. By requiring that petitioner add the *unrevalued* dollar balance of Progressive's reserves to its January 1 balance,[14] the regulations deny to petitioner a deduction that would duplicate the total deductions with respect to such amount that Progressive took during its taxable years up to and including 1970. By not requiring that petitioner add the *revalued* amount to its January 1 balance, the regulations adjust for the fact that the shoes do not exactly fit (i.e., because petitioner had elected under section 818(c) and Progressive had not) by treating the situation as if *petitioner* had issued the acquired policies on their dates of actual issuance and under its section 818(c) election. Because Progressive had, as of August 19, 1970, already taken part of the deduction to which this scenario would entitle petitioner (i.e., that portion of the deduction for yearly increases in reserves resulting from Progressive's valuation of each year's new reserves on a preliminary term basis each December 31), the regulations allow petitioner only the remaining deduction under this scenario (i.e., the aggregate of the yearly deductions that petitioner would have taken had it issued Progressive's policies when they were actually issued and under its section 818(c) election, less the aggregate of the yearly deductions that Progressive actually took).

Respondent's view in the instant case incorrectly treats the situation as if petitioner held all the acquired policies on January 1, 1970 and made the election as to those policies on August 19, 1970, retaining its earlier election as to its other policies. Thus, respondent would require that petitioner revalue the acquired policies on August 19 and add the revalued amount to its opening balances, and would entirely deny the yearly deductions that petitioner would have received had it issued Progressive's policies when they were actually issued. Petitioner's view accomplishes the goal of accommodating the

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[14] We note that the parties agree that the regulations require that petitioner must add at least this much to its opening balance. For a discussion of what we believe to be the actual requirement of the regulations under sec. 381, see *infra* pp. 527–528.

policy behind section 381 and the practical difficulties of the instant case, and we therefore hold for petitioner on the issue of the reflection of Progressive's reserves in petitioner's opening balance.[15]

We are constrained to point out that both parties appear to stray from the actual method by which the statutory and regulatory scheme produces the correct result in the instant case. Section 381 provides merely that the acquiring corporation "shall succeed to and take into account" the section 381(c) items; it is left to section 481 to work out the tax adjustments required due to any duplications or omissions resulting from such taking into account. See sec. 1.381(c)(4)–1(a)(1)(ii), *supra*; sec. 1.381(c)(4)–1(c)(3), example (*1*), Income Tax Regs. In the instant case, the parties are in agreement that (1) at the minimum, the unrevalued dollar balances of the acquired reserves must be added to petitioner's opening balances and (2) if we were to decide, as we do, that the revalued amounts need not be added to petitioner's opening balances, there is no issue under section 481. As we noted above, however, nothing in section 381 or its regulations actually requires that the merger in issue have *any* effect on petitioner's opening balances (and thus its section 810 calculation) for 1970, as the reserves therefrom were acquired during the taxable year. Given the respective roles of sections 381 and 481, the proper method by which to reach the correct result herein appears to be (1) to require petitioner under section 381 to take the acquired reserves (revalued or unrevalued) into its accounts on August 19, 1970; (2) to require no addition to petitioner's January 1, 1970 reserve balance with respect to the acquired reserves; (3) to allow petitioner a section 810 increase, relating to the acquired reserves, of $2,088,955 over its January 1, 1970 reserve balance; and (4) to adjust petitioner's section 810(d)(2) deduction down to $904,737 under section 481 due to the fact that Progressive had already taken $1,184,218 of the $2,088,955 deduction. As the parties framed the issues as they

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[15] See G. Lenrow, R. Milo & A. Rua, Federal Income Taxation of Insurance Companies 111 (3d ed. 1979); 2 R. Antes, A. Simmons & R. McCormack, Federal Income Taxation of Life Insurance Companies, sec. 53.04, at 33–16 (1984). We note that our conclusion is at odds with respondent's ruling on similar facts in Rev. Rul. 80–116, 1980–1 C.B. 141, a ruling not relied on by respondent herein and, in any event, based on questionable reasoning. See 2 R. Antes, A. Simmons & R. McCormack, *supra* at 33–27 to 33–36.

did, however, we can do no more than to note the true relationship of sections 381 and 481.[16]

Issue 2

FINDINGS OF FACT

During the years in issue, petitioner had in force life insurance contracts issued under policy plans P8, P9, O1, OO, and OL that provided death benefits varying with the duration of the contract. Each of the contracts issued under these policy plans is a single contract of life insurance for which a single gross premium is charged the policyholder, and is of a type that has been sold by the life insurance industry since at least the 1940's.

Petitioner acquired policy plans P8 and P9 as a result of the merger of Progressive with and into petitioner. Each of the life insurance contracts under policy plans P8 and P9 provides that the following total amount is payable upon the death of the insured: (1) A stated amount of death benefit (referred to in the contract and hereinafter as the Face Amount); (2) an additional amount of death benefit (the Additional Death Benefit), equal to the Face Amount if death occurs prior to the end of the 15th policy year; and (3) an additional amount of death benefit (the Return of Premium Death Benefit), equal to the contract's annual gross premium multiplied by the number of full years for which premiums have been paid prior to death, if death occurs prior to the earlier of the end of the 20th policy year or age 65. Level annual gross premiums are payable for the life of the insured by the policyholder of a contract issued under policy plan P8 or P9.

Each of the life insurance contracts petitioner issued under policy plan O1 provides that the following total amount is payable upon the death of the insured: (1) A stated amount of death benefit (referred to in the contract and hereinafter as

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[16] But for the limitation contained in sec. 481(b), i.e., proration where the adjustment exceeds $3,000, the result produced by the application of the suggested methodology would produce the same result as we have in fact reached herein.

We express no opinion on the precise effect of the "as if" language found in sec. 1.381(c)(4)-1(c)(1), Income Tax Regs., discussed at pp. 520, 521-523, *supra*, on this suggested approach. In order to do so, we would have to know how much of Progressive's reserve represented policies written during 1970, a fact that appears nowhere in the record herein. Suffice it to say that a proper application of the "as if" provision—i.e., to calculate the sec. 481 adjustment, rather than to effect the taking into account of Progressive's reserves under sec. 381—would not necessarily require increasing petitioner's opening balance by the full $2,088,955.

the Sum Insured), and (2) an additional amount of death benefit (the Return of Premium Death Benefit), equal to the sum of all annual gross premiums paid prior to death, if death occurs during the first 20 policy years. Level annual gross premiums are payable, until the earlier of the insured's death or the passage of 20 policy years, by the policyholder of a contract issued under policy plan O1.

Each of the life insurance contracts petitioner issued under policy plan OO is labeled "Whole Life Insurance Policy with Varying Amount of Insurance," and provides that the following total amount is payable upon the death of the insured: (1) A stated amount of death benefit (referred to in the contract and hereinafter as the Basic Amount of Insurance) that varies with the insured's age at issue and the policy year in which death occurs, and (2) an additional amount of death benefit (referred to in the contract and hereinafter as the Insured Annual Income Death Benefit) equal to an amount that varies with the insured's age at issue and the policy year in which death occurs, which is payable in the event of death before age 65. The following is an excerpt from the Table of Amount of Insurance set forth in the contracts, which indicates the total benefit payable at death occurring during various policy years:

		Figures applicable if beneficiary elects commuted value of insured annual income at insured's death	
Attained age	*Basic amount of insurance*	*Commuted value of insured annual income*	*Total amount payable*
0	$2,500	$19,659	$22,159
1	2,500	19,535	22,035
5	2,500	19,009	21,509
10	2,500	18,274	20,774
15	2,500	17,443	19,943
20	8,125	16,503	24,628
25	13,750	15,438	29,188
30	19,375	14,235	33,610
35	25,000	12,873	37,873
40	25,000	11,331	36,331
45	25,000	9,588	34,588
50	25,000	7,615	32,615
55	17,500	5,383	22,883
60	10,000	2,857	12,857
65 and life	2,500	0	2,500

Level annual gross premiums are payable by a policyholder of a contract issued under policy plan OO until the earlier of the insured's attaining age 65 or the insured's death.

Each of the life insurance contracts petitioner issued under policy plan OL is labeled "Modified Premium Whole Life Policy with Reducing Term," and provides that the total amount payable upon the death of the insured (referred to in the contract and hereinafter as the Amount of Insurance) is to be determined from a Table of Amounts of Insurance per $1,000 of Ultimate Amount, which is incorporated as part of the contract and which set forth the amount of death benefit payable depending on the insured's age at issue and on the policy year in which death occurs. The following is an excerpt from such table:

	Age at issue			
Policy year of death	*45 and under*	*50*	*55*	*60*
1	$2,000	$2,000	$2,000	$2,000
2	1,950	1,934	1,900	1,800
3	1,900	1,867	1,800	1,600
4	1,850	1,800	1,700	1,400
5	1,800	1,734	1,600	1,200
6	1,750	1,667	1,500	1,000
7	1,700	1,600	1,400	1,000
8	1,650	1,534	1,300	1,000
9	1,600	1,467	1,200	1,000
10	1,550	1,400	1,100	1,000
11	1,500	1,334	1,000	1,000
12	1,450	1,267	1,000	1,000
13	1,400	1,200	1,000	1,000
14	1,350	1,134	1,000	1,000
15	1,300	1,067	1,000	1,000
16	1,250	1,000	1,000	1,000
17	1,200	1,000	1,000	1,000
18	1,150	1,000	1,000	1,000
19	1,100	1,000	1,000	1,000
20	1,050	1,000	1,000	1,000
21 and up	1,000	1,000	1,000	1,000

Except for the first year gross premium, level annual gross premiums are payable for the life of the insured by a policyholder of a contract issued under policy plan OL. Petitioner first issued contracts under policy plan OL in 1973.

Petitioner, in calculating for the contracts issued under these policy plans the gross premium, the net premium, the reserve, and the cash value,[17] treated each such contract as a single, unitary contract of life insurance. The death benefit that was payable at any point in time under each contract issued under policy plan P8, P9, O1, OO, or OL was contractually fixed from the issue date of each contract and could not be altered thereafter by either the policyholder or petitioner. If an applicant for insurance desired to purchase from petitioner only some portion of the death benefit payable under a contract issued under such policy plans, and did not desire to purchase the entire death benefit payable under such a contract, such person could not purchase separately, and petitioner did not sell separately, such a portion of the entire death benefit payable under such a contract. Neither petitioner nor the policyholder of a contract issued under policy plan P8, P9, O1, OO, or OL could cancel or otherwise terminate some portion of the death benefit under such contract while keeping other portions of the death benefit under such contract in force. In those cases in which petitioner required an applicant for a contract issued under such policy plans to have a medical examination prior to issuance of such contract, a medical examination was required only prior to the issuance of such contract and no additional medical examination was required prior to any increases in the death benefit that might be scheduled to take place pursuant to the terms of such contract.

Each of the life insurance contracts issued under policy plans P8, P9, O1, OO, and OL requires the periodic payment of a gross premium. Such gross premium was not segregated by petitioner into parts, nor was any portion of such premium identified by petitioner in such contracts, or elsewhere, with some portion of the death benefit under such contracts. Rather, such gross premium was calculated by petitioner and payable by the policyholder for the entire death benefit under each such contract. Each periodic gross premium paid by a

[17] The cash value of a life insurance contract is the amount that a life insurance company is contractually obligated to pay the policyholder of the contract in the event that such policyholder surrenders the contract to the insurance company. The minimum amount of cash value that a life insurance company must provide under a life insurance contract is prescribed by the State nonforfeiture law.

policyholder with respect to a contract issued under policy plan P8, P9, O1, OO, or OL was paid with respect to the death benefit under the contract, including the past and future death benefit, and was not paid only with respect to the amount of such death benefit that was in force at the time of the premium payment. The gross premium payable with respect to each of the contracts issued under such policy plans was level throughout the entire premium-paying period, except that the gross premium for the first policy year under a contract issued under policy plan OL was larger than the gross premium in subsequent years.

The net premium with respect to each of the contracts issued under policy plans P8, P9, O1, OO, and OL was a net premium calculated and established by petitioner for the death benefit under each contract. Such net premium was not segregated by petitioner into parts, nor was any portion of such net premium identified by petitioner in such contracts, or elsewhere, with some portion of the death benefit under such contracts. Petitioner took into account in computing the net premium the entire death benefit for all policy years under each such contract.

Petitioner calculated and held a statutory life insurance reserve in respect of the death benefit under each of the contracts issued under policy plans P8, P9, O1, OO, and OL. It did not calculate and hold one statutory reserve with respect to some portion of the death benefit under the contracts issued under such policy plans and a separate statutory reserve with respect to some other portion of the death benefit under such contracts. The statutory life insurance reserve petitioner calculated and held in respect of each of the contracts issued under policy plans P8, P9, O1, OO, and OL was calculated and held in respect of the death benefit payable under each such contract at all durations. Thus, for example, in the first policy year, the statutory reserve calculated and held by petitioner with respect to a contract issued under policy plan P8 was the excess of the present value of the future death benefit under such contract over the present value of the future net premiums under such contract. Petitioner reported in its annual statements the aggregate of the statutory life insurance reserve in respect of the death benefit under each of the contracts issued under policy plans P8, P9, O1, OO, and OL.

Petitioner did not report in its annual statements an aggregate statutory reserve with respect to some portion of the death benefit under the contracts issued under such policy plans and a separate aggregate statutory reserve with respect to some other portion of the death benefit under such contracts. The aggregate of the statutory life insurance reserve in respect of the death benefit under each of the contracts issued under policy plans P8, P9, O1, OO, and OL that petitioner reported in its annual statements was reported with respect to the death benefit payable under such contracts at all durations. The statutory life insurance reserves petitioner calculated and held with respect to contracts issued under policy plans P8, P9, O1, OO, and OL were calculated on the basis of (1) the 1958 Commissioners Standard Ordinary Mortality Table, (2) an assumed rate of interest of 3 percent, and (3) the Commissioners Reserve Valuation Method, which is a recognized preliminary term method within the meaning of section 1.818–4(a), Income Tax Regs. Such statutory life insurance reserves were life insurance reserves within the meaning of section 801(b).

Petitioner calculated a cash value in respect of the death benefit under each of the contracts issued under each of the policy plans P8, P9, O1, OO, and OL. It did not calculate one cash value with respect to some portion of the death benefit under the contracts issued under such policy plans and a separate cash value with respect to some other portion of the death benefit under such contracts.

Some life insurance companies issue to the same person (1) contracts of permanent insurance[18] to which are attached one or more riders[19] that provide term insurance,[20] and/or (2) contracts of permanent insurance and separate contracts of term insurance. In issuing the contracts under policy plans P8, P9, O1, OO, and OL, petitioner did not issue to the same person

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[18]Permanent insurance is any form of life insurance other than term insurance.

[19]A rider is a separate contractual provision that is attached to a life insurance contract and that usually expands the benefits provided under such life insurance contract. If a rider expands the benefits under the life insurance contract to which it is attached by providing, for example, term insurance, a separate gross premium is charged the policyholder for the term insurance rider, in addition to the separate gross premium charged the policyholder for the contract of life insurance to which such rider is attached.

[20]Term insurance is, in a general sense, life insurance provided for a limited period of time, the face amount of the policy being payable only if death occurs during the limited period of time. The specific definition of term insurance under sec. 818(c) will be discussed in more detail below.

(1) contracts of permanent insurance to which are attached one or more riders that provide term insurance, or (2) contracts of permanent insurance and separate contracts of term insurance. Moreover, during the years in issue, petitioner did not provide the same benefits provided by any of such policy plans under either a permanent contract with one or more term insurance riders or a contract of permanent insurance and a separate contract of term insurance.

The death benefits under a contract of permanent insurance to which is attached a term insurance rider are separable. Thus, the policyholder of a contract of permanent insurance to which is attached a term insurance rider can stop paying the separate, additional gross premium for the term insurance rider and allow such term insurance rider to lapse, while continuing to pay the separate gross premium for the contract of permanent insurance and keeping such contract of permanent insurance in force. However, a term insurance rider will not continue in force if the contract of permanent insurance to which such rider is attached is terminated. The respective death benefits under separate contracts of permanent insurance and term insurance issued to the same person are likewise separable. Thus, the policyholder of both a contract of permanent insurance and a contract of term insurance can stop paying the separate gross premium for either contract and allow such contract to lapse, while continuing to pay the separate gross premium for the other contract and keeping such other contract in force. In addition, a person can purchase a contract of permanent insurance from a life insurance company without purchasing a contract of term insurance; such person can also purchase a contract of term insurance without purchasing a contract of permanent insurance.

A life insurance company that issues a contract of permanent insurance to which is attached a term insurance rider calculates one gross premium, one net premium, one statutory reserve, and one cash value with respect to the contract of permanent insurance and a separate, additional gross premium, a separate net premium, a separate statutory reserve, and a separate cash value (if there is a cash value) with respect to the term insurance rider. A life insurance company that issues to the same person both a contract of permanent insurance

and a contract of term insurance similarly calculates one gross premium, one net premium, one statutory reserve, and one cash value with respect to the contract of permanent insurance and a separate, additional gross premium, a separate net premium, a separate statutory reserve, and a separate cash value (if there is a cash value) with respect to the contract of term insurance. Because of the additional administrative expenses typically associated with issuing either a contract of permanent insurance to which is attached a term insurance rider or a contract of permanent insurance together with a separate contract of term insurance, a company will typically charge aggregate gross premiums for the contract with a rider or for the separate contracts that exceed the gross premium charged for a single contract providing an identical amount of death benefit.

The NAIC has promulgated a model law, the Standard Valuation Law, that sets forth minimum standards for the calculation, or "valuation," of life insurance reserves. The NAIC has also promulgated a model law, the Standard Nonforfeiture Law, that sets forth minimum nonforfeiture benefits under life insurance contracts. Because petitioner was domiciled in the State of Tennessee, it was subject to the requirements of the Standard Valuation Law as in effect in the State of Tennessee during the years in issue (the Tennessee Standard Valuation Law) and the Standard Nonforfeiture Law as in effect in the State of Tennessee during the years in issue (the Tennessee Standard Nonforfeiture Law), both of which were interpreted and administered by the Tennessee Department of Insurance. Petitioner was also subject to the requirements of all the States in which it was authorized to do business. It is a principal concern of the Tennessee Department of Insurance that statutory reserves be sufficient to cover future benefits provided under insurance contracts and that an insurance company be solvent.

In each of the years in issue, the Tennessee Standard Valuation Law, as interpreted and administered by the Tennessee Department of Insurance, required an insurance company issuing a life insurance contract providing an amount of death benefit that varies with the duration of the contract to calculate and hold, as a minimum amount of statutory reserves, a statutory life insurance reserve in an amount

calculated on a preliminary term basis in respect of the death benefit provided under the contract. In each of the years in issue, petitioner valued and reported in exhibit 8 of its annual statements, in accordance with the requirements of the Tennessee Standard Valuation Law applicable to a contract providing an amount of death benefit that varies with the duration of the contract, the statutory reserves with respect to contracts issued under each of the policy plans P8, P9, O1, OO, and OL. For each of the years in issue, a valuation certificate was issued annually to petitioner by the Tennessee Department of Insurance that certified therein that petitioner was authorized to do business in Tennessee. The Department further certified that petitioner had valued its statutory reserves in accordance with the requirements of Tennessee law, and it set forth the dollar amount of such reserves and the description of the bases on which they were computed by reference to exhibit 8 of the annual statement. Petitioner's statutory reserves with respect to contracts issued under policy plans P8, P9, O1, OO, and OL, valued on the preliminary term basis, were included in the statutory reserves certified in the department's valuation certificates for each of the years in issue. For each of the years in issue, the statutory reserves with respect to contracts issued under policy plans P8, P9, O1, OO, and OL that petitioner valued and reported in its annual statements were accepted by the Tennessee Department of Insurance as held for the fulfillment of the future unaccrued claims of policyholders or beneficiaries of contracts issued by petitioner under such policy plans. Once petitioner's statutory reserves with respect to contracts issued under policy plans P8, P9, O1, OO, and OL were established on the basis prescribed by Tennessee law and reported in its annual statements to the Tennessee Department of Insurance, petitioner was required by Tennessee statutory provisions and by the rules and regulations of the department to maintain such reserves on such basis and not to reduce or "weaken" such reserves by changing such basis without the approval of the department.

During the years in issue, the Tennessee Standard Nonforfeiture Law required nonforfeiture benefits to be provided in the form of cash surrender values, extended term insurance, and reduced paid-up insurance. During the years in issue, the

Tennessee Standard Nonforfeiture Law provided for the calculation of cash values on one basis for any policy providing term insurance benefits by rider or supplementary policy provision and on another basis for any policy providing an amount of death benefit that varies with the duration of the policy. During the years in issue, petitioner calculated the cash value of each contract issued under each of the policy plans P8, P9, O1, OO, and OL under the provision of the Tennessee Standard Nonforfeiture Law applicable to policies providing an amount of death benefit that varies with the duration of the policy, and not under the provision of that law applicable to policies providing term insurance benefits by rider or supplemental policy provision.

On its annual statements for the years in issue, petitioner reported certain of the death benefits payable with respect to policy plans P8, P9, O1, OO, and OL on the lines provided for reporting amounts of term insurance, as follows:

Annual statement	*Policy plan*	*Death benefit*	*How reported*
1970	O1	Return of premium	"Other term insurance"
1971	P8, P9	Additional death benefit	"Term policies—other"
		Return of premium	"Other term insurance"
	O1	Return of premium	"Other term insurance"
1972	P8, P9	Additional death benefit	"Other term insurance—decreasing"
	OO	Insured annual income	"Other term insurance—decreasing"
1973	O1	Return of premium	"Other term insurance"
	P8, P9	Additional death benefit	"Other term insurance"
1974	P8, P9	Additional death benefit	"Other term insurance"

Based on the documents that petitioner has in its possession, it cannot be determined whether petitioner reported any of the death benefit payable with respect to any of the contracts issued under policy plan P8, P9, O1, or OO as "other term insurance" on its annual statement for 1972, or as "other term insurance—decreasing" on its annual statements for 1973 and 1974. Petitioner did not report as term insurance any of the

death benefit payable under policy plan OL on its 1972, 1973, and 1974 annual statements.

In various documents, employees of petitioner calculated the reserves with respect to the death benefits under the contracts issued under policy plans P8, P9, O1, OO, and OL. For the most part, these documents do not reflect calculations for each of the separate components of the death benefit payable under contracts issued under the policy plans at issue. However, a worksheet prepared by an unidentified employee of petitioner does contain entries representing the aggregate of the Additional Death Benefit with respect to all contracts issued and in force under policy plans P8 and P9 as of December 31, 1973 and December 31, 1974, the aggregate of the Return of Premium Death Benefit with respect to all such contracts under policy plan O1 as of such dates, and the aggregate of the initial Basic Amount of Insurance with respect to all such contracts under policy plan OO as of such dates. Additionally, a worksheet prepared by an unidentified employee of petitioner in connection with the development of certain financial statements by petitioner's independent accountants contains entries representing the aggregate of the initial Insured Annual Income Death Benefit with respect to all contracts issued and in force under policy plan OO as of December 31, 1974 and June 30, 1975, the aggregate of the initial Basic Amount of Insurance for such contracts under policy plan OO as of such dates, the aggregate of the Additional Death Benefit for such contracts under policy plans P8 and P9 as of such dates, and the aggregate of the Face Amount for such contracts under policy plans P8 and P9 as of such dates. Similarly, a document entitled "Reserve Valuation Summary by Plan," prepared by petitioner in the first two months of 1974, contains entries representing the aggregate of the Additional Death Benefit with respect to all contracts issued and in force under policy plans P8 and P9 as of December 31, 1973, the aggregate of the Face Amount with respect to such contracts under policy plans P8 and P9 as of such date, the aggregate of the initial Insured Annual Income Death Benefit with respect to such contracts under policy plan OO as of such date, and the aggregate of the initial Basic Amount of Insurance with respect to such contracts under policy plan OO as of such date.

On its tax return for each of the years 1971 and 1973, petitioner failed to take account of the Return of Premium Death Benefit under contracts issued under policy plans P8 and P9 in revaluing under section 818(c) its reserves in respect of contracts issued under each such plan. On its tax return for each of the years 1970 through 1974, except as just indicated, petitioner made a revaluation in respect of the Additional Death Benefit and the Return of Premium Death Benefit provided under contracts issued under policy plans P8 and P9 under section 818(c)(2)(B) on the basis of $5 per $1,000 of such death benefits in force. Petitioner did not allocate any portion of the statutory reserves it held in respect of contracts issued under policy plans P8 and P9 to the Additional Death Benefit or to the Return of Premium Death Benefit, and did not reduce by 0.5 percent of reserves in respect of such part of the death benefit the amount of approximate revaluation it had calculated under section 818(c)(2)(B) with respect to such part. Except as described above, on its tax return for each of the years 1970 through 1974, petitioner revalued the reserves for contracts issued under policy plans P8 and P9 under section 818(c)(2)(A) on the basis of $21 per $1,000 of insurance in force, less 2.1 percent of the reserves under such contracts.

On its tax return for each of the years 1970 through 1974, petitioner made a revaluation in respect of the Return of Premium Death Benefit provided under contracts issued under policy plan O1 under section 818(c)(2)(B) on the basis of $5 per $1,000 of such death benefit in force. Petitioner did not allocate any portion of the statutory reserves it held in respect of contracts issued under policy plan O1 to the Return of Premium Death Benefit, and did not reduce by 0.5 percent of reserves in respect of such part of the death benefit the amount of approximate revaluation it had calculated under section 818(c)(2)(B) with respect to such part. Except as described above, on its tax return for each of the years 1970 through 1974, petitioner revalued the reserves for contracts issued under policy plan O1 under section 818(c)(2)(A) on the basis of $21 per $1,000 of insurance in force, less 2.1 percent of the reserves under such contracts.

On its tax return for each of the years 1970 through 1974, petitioner failed to include reserves attributable to several contracts issued under policy plan OO in making the revalua-

tion under section 818(c) of its reserves in respect of contracts issued under such plan. Except as indicated above, on its tax return for such years, petitioner made a revaluation in respect of a part of the death benefit under contracts issued under policy plan OO under section 818(c)(2)(B) on the basis of $5 per $1,000 of insurance in force with respect to such portion. Petitioner did not allocate any portion of the statutory reserves it held in respect of contracts issued under its policy plan OO to such part of the death benefit, and did not reduce by 0.5 percent of reserves in respect of such part of such death benefit the amount it calculated under section 818(c)(2)(B) with respect to such part. Otherwise, on its tax return for such year, petitioner revalued the reserves for contracts issued under policy plan OO under section 818(c)(2)(A) on the basis of $21 per $1,000 of insurance in force, less 2.1 percent of the reserves under such contracts.

On its tax return for each of the years 1973 and 1974, petitioner revalued its reserves for contracts issued under policy plan OL under section 818(c)(2)(A) on the basis of $21 per $1,000 of insurance in force, less 2.1 percent of the reserves under such contracts. Petitioner also made a section 818(c)(2)(B) revaluation on its tax return for such years in respect of a return of premium death benefit under contracts issued under policy plan OL. Such contracts did not in fact provide for a return of premium death benefit.

Respondent determined as follows as regards contracts issued under the policy plans in issue:

Policy plan	*Portion of death benefit*	*Respondent's characterization*
P8 and P9	Face amount	Other than term insurance
	Return of premium (under contracts issued to individuals whose age was less than 50 years)	Term insurance of more than 15 years
	Additional death benefit	Term insurance of 15 years or less
O1	Sum insured	Other than term insurance

Policy plan	*Portion of death benefit*	*Respondent's characterization*
	Return of premium	Term insurance of more than 15 years
OO	Basic amount of insurance	Part other than term insurance, part term insurance of more than 15 years
	Insured annual income	Term insurance of more than 15 years
OL	Amount of insurance	Part other than term insurance part, term insurance of more than 15 years

Respondent did not allocate any portion of the statutory reserves held by petitioner in respect of (1) contracts issued under policy plans P8 and P9 to the Return of Premium Death Benefit or to the Additional Death Benefit under such contracts, (2) contracts issued under policy plan O1 to the Return of Premium Death Benefit under such contracts, (3) contracts issued under policy plan OO to the Insured Annual Income Death Benefit or to the portion of the Basic Amount of Insurance under such contracts that respondent treated as term insurance of more than 15 years, and (4) contracts issued under policy plan OL to the portion of the Amount of Insurance under such contracts that respondent treated as term insurance of more than 15 years.

OPINION

The issue for decision is by what amount the reserves in respect of petitioner's contracts issued under Plans P8, P9, O1, OO, and OL should be revalued. During the years at issue, a life insurance company that elected, under section 818(c), to revalue on the net level premium method its reserves computed on a preliminary term basis (see *supra* pp. 516–517 could do so either by means of an exact revaluation under section 818(c)(1) or an approximate revaluation under section 818(c)(2) on the following basis:

(2) APPROXIMATE REVALUATION.—The amount computed [on a preliminary term basis]—

(A) increased by $21 per $1,000 of insurance in force (other than term insurance) under such contracts, less 2.1 percent of reserves under such contracts, and

(B) increased by $5 per $1,000 of term insurance in force under such contracts which at the time of issuance cover a period of more than 15 years, less 0.5 percent of reserves under such contracts.

Resolution of the dispute between the parties turns upon a determination of whether the insurance under the contracts in issue falls wholly within (A) or (B), partly within each, or within neither. Respondent contends that, in order to make such a determination, insurance coverage under the contracts should be segregated into its term and permanent[21] components. Petitioner counters with the assertion that such segregation is not proper and that, since each of the contracts was issued as a single, unitary insurance policy and contained an element of coverage which is properly characterized as "other than term," i.e., permanent, insurance, only the adjustments provided for in section 818(c)(2)(A) are applicable.

The issue of unitary view versus segregated view affects four elements involved in the application of section 818(c)(2)(A) and (B):

(1) whether the insurance should be categorized as term insurance having a term of 15 years or less, in which event neither (A) nor (B) applies;

(2) which flat dollar per thousand increase ($21 or $5) should be used with respect to insurance to which (A) or (B) applies;

(3) the calculation of the amount of insurance to which the $21 or $5 increase applies; and

(4) the calculation of the amount of reserves to which the percentage decreases in (A) or (B) apply.

In determining whether we should adopt the unitary view advocated by petitioner or the segregated view advocated by respondent, we look first to the applicable statutory provisions. Both parties claim that the language and structure of the provisions support their view. Respondent contends that the placement in section 818(c)(2)(A) of the parenthetical

[21] For the sake of convenience and pursuant to industry usage, we will refer to insurance other than term insurance as "permanent" insurance. See *supra* note 18.

phrase "(other than term insurance)" after "insurance in force" and before the phrase "under such contracts," and the use of the conjunctive "and" between subparagraphs (A) and (B), indicate that the individual contracts should be split into components, i.e., the segregated view. Petitioner asserts that the use of the plural verb "cover" in subparagraph (B) indicates that it modifies "contracts" rather than "insurance," thus demonstrating a legislative intention that the requisite determination be made on the basis of whole contracts, i.e., the unitary view. Additionally, we note that the word "contracts" also appears in the portions of section 818(c) preceding subsections (c)(2)(A) and (B).

We think that the use of the word "cover" does not preclude segregation of components, but merely indicates that if there is a term policy which contains coverage in excess of 15 years, it will be eligible for some subparagraph (B) adjustment. Similarly, we think that the use of the word "contracts" goes only to the contracts, i.e., life insurance policies, with respect to which reserves are to be calculated, and does not preclude a breakdown of those calculations based upon the component elements of coverage set forth in those contracts. The most that can be said is that there may be some ambiguity in the statutory language. Under these circumstances, we may look to the legislative history in an effort to ascertain what Congress intended. See *Colony, Inc. v. Commissioner*, 357 U.S. 28, 33 (1958); see also *Bates v. United States*, 581 F.2d 575, 579–580 (6th Cir. 1978); *Huntsberry v. Commissioner*, 83 T.C. 742, 747–748 (1984).

The committee reports on the provision enacted as section 818(c) explain the revaluation technique as follows:

> Under [the approximate] method, with respect to contracts for which reserves are computed under the preliminary term basis, the reserves are increased by *the sum of* (A) $21 per $1,000 of *insurance in force* (other than term insurance), less 2.1 percent of reserves therefor, and (B) $5 per $1,000 of term *insurance in force* under contracts which at the time of issuance cover a period of more than 15 years, less 0.5 percent of reserves therefor.
>
> If the taxpayer elects one of the two methods provided in this subsection, *all contracts* for which life insurance reserves are computed on a preliminary term basis *must be so converted*. [H. Rept. 34, 86th Cong., 1st Sess. (1959), 1959–2 C.B. 736, 766–767; S. Rept. 291, 86th Cong., 1st Sess. (1959), 1959–2 C.B. 770, 824. Emphasis added.]

We think that the phrase "the sum of" combined with the phrase "insurance in force" indicates that Congress was focusing on the amount of each type of coverage. This conclusion is reinforced by the fact that, in describing the coverage to which the $21 increase applies, the committee reports omit any reference to "contracts." The use of the word "contracts" in the final sentence of the committee report seems to us to say only that if an insurance company elects to come within section 818(c), its election must cover "all [eligible] contracts" whether term or permanent, and does not preclude segregation of the components of the covered contracts.[22]

We likewise find no clear-cut indication of congressional intent in the legislative history at the time section 818(c)(2) was amended in 1982, reducing the revaluation factor under subparagraph (A) to $19 per $1,000 of insurance in force and 1.9 percent of reserves.[23] See Pub. L. 97-248, sec. 267(a)(1), 96 Stat. 550-551 (1982). The Senate Finance Committee report accompanying that legislation stated—

> The committee has been informed that some policies which are in substance renewable term policies eligible only for, at most, the $5 per thousand approximate revaluation adjustment have been labeled "whole life" policies so that the issuing company may claim the higher revaluation adjustment for insurance other than term insurance. * * *While the committee recognizes that certain graded premium policies may be appropriately treated as whole life policies, the committee is concerned that many graded premium policies are not entitled to the reserve deductions claimed by the issuing companies. It is the committee's understanding that whole life policies eligible for the $19 per thousand reserve revaluation adjustment should either have a substantial cash surrender value within several years after the policy is issued or level premiums should be charged within a relatively short period of time after the policy is issued. The committee expects the Treasury Department to issue regulations dealing with this matter. [S. Rept. 97-494, at 341 (1982). Fn. ref. omitted.]

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[22] We note that the legislative committees which dealt with the Life Insurance Company Income Tax Act of 1959 were made aware of the existence of combination and/or fluctuating coverage policies, but not in the context of matters covered by sec. 818(c). See Taxation of Income of Life Insurance Companies: Hearings Before a Subcomm. of the House Comm. on Ways and Means, 85th Cong., 2d Sess. 212-213 (1958).

[23] We note that, in any event, the use of such legislative history (some 23 years after sec. 818(c) was enacted) would at best be hazardous. See *Waterman Steamship Corp. v. United States*, 381 U.S. 252, 269 (1965); *Knowlton v. Commissioner*, 84 T.C. 160, 169 (1985).

While it can be argued that the references to "graded premium policies" indicate that the Senate Finance Committee was thinking in terms of contracts rather than component coverage, it can equally be asserted that the committee was simply saying that to be eligible at all for the reduced $19-per-thousand increase, certain conditions would have to be met, i.e., substantial cash surrender value or early level premiums, without implying that once eligibility was established, it should apply to the entire coverage provided by the policy. See Report to the Congress by the Comptroller General, "Billions of Dollars Are Involved in Taxation of the Life Insurance Industry—Some Corrections in the Law are Needed" 64–66 (1981), cited in S. Rept. 97–494, at 341 (1982).

Left with no firm guidance from the legislative history, we think it appropriate to consider the segregated-versus-unitary issue in light of the policy underlying the enactment of section 818(c). We conclude that the segregation of a given policy into its component elements of coverage is more in keeping with that policy. The committee reports on the Life Insurance Company Income Tax Act of 1959, the legislation containing section 818(c), explain that, for tax purposes, there is—

> a hardship on insurance companies using preliminary term reserves as compared with those which use ordinary [net level premium] reserves, since the policy and other contract liability deduction depends on the size of the reserves. Moreover, additions to the reserves, deductible under phase 2, also would in some cases be smaller. To avoid this result, life insurance companies which have computed their reserves on a preliminary term basis are permitted to recompute their reserves on a net level premium basis. This can be done either by an exact revaluation of the reserves to a net level premium basis *or by approximating this result under a formula set forth in the bill.* [H. Rept. 34, *supra*, 1959–2 C.B. at 748; S. Rept. 291, *supra*, 1959–2 C.B. at 792. Emphasis added.]

The rationale behind the formula chosen by Congress in section 818(c)(2) appears to be that, for equal amounts of insurance, net level premiums in the early years of a permanent insurance policy are necessarily higher than those for a term policy.[24] Because preliminary term reserve methods

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[24] "This is true due to the nature of term insurance, which insures only against the *contingency* of death within the stated term, as opposed to permanent insurance, which insures against the *certainty* of eventual death. See D. McGill, Life Insurance 44 (rev. ed. 1967). Because level gross premiums under a permanent insurance contract generally greatly exceed, in the early policy years, the actual cost of insuring against then-improbable deaths, permanent insurance builds

generally produce comparable reserves for term and permanent insurance, there is, on the average, a larger difference between net level premium reserves and preliminary term reserves in the early policy years for permanent insurance than for term insurance, resulting in the need for the greater revaluation factor in section 818(c)(2)(A) than in section 818(c)(2)(B).

It is clear, then, that the differential between exact revaluation, i.e., use of a net level premium basis, and valuation on a preliminary term basis to compute the reserve with respect to a pure permanent policy is greater than the comparable differential with respect to a pure term policy, and that the approximate formula contained in section 818(c)(2) was intended to compensate for these differentials. It is equally clear that to the extent that term coverage is accorded the benefit of the formula applicable to permanent insurance, the life insurance companies are obtaining reserve deductions in excess of those which would have been obtained had the term coverage been separately revalued. Indeed, the element of overcompensation was involved in the change in the formula for insurance "other than term insurance" under section 818(c)(2)(A), enacted by Congress in 1982. See *supra* p. 544.[25]

In arguing that the applicability of section 818(c)(2)(A) and (B) should be determined on a "contract", i.e., unitary, basis, petitioner points to what it considers to be significant differences between the policies involved herein and the situation which would have obtained had each of the coverage elements in those policies been provided either in separate contracts or in a permanent insurance policy with riders attached. In the latter cases, there would have been separate premiums,

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substantial cash values. To hold reserves adequate to cover policy risks and these cash values, companies must add larger net premiums in the early policy years to its reserves with respect to permanent insurance contracts than to its reserves with respect to term insurance contracts. See *supra* notes 3 and 7.

[25] In pointing to the policy element of the legislative history of sec. 818(c), we do not accept respondent's position that there is an abuse of the provisions of sec. 818(c) for which petitioner should be penalized simply because it calculated higher reserves for the contracts in issue using the approximate revaluation method than it would have calculated using the exact revaluation method. See Staff of Joint Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 597 (Comm. Print 1984) (explaining prior law); Rev. Rul. 77-312, 1977-2 C.B. 235. We note that respondent's expert actuarial witness, Dr. Kabele, testified at trial that the $21 per $1,000 revaluation formula under sec. 818(c)(2)(A) itself yields reserves of varying accuracy as compared with the exact method depending on the insured's age at issuance, resulting in "fairly accurate" deductions on contracts issued at age 35, insufficient deductions at age 45, and excessive deductions at age 55.

separate administrative costs, separate reserves, and separate rights of the policy holder, i.e., the ability to terminate one part of the coverage (other than the permanent coverage) and to keep the remaining parts in force.[26] With respect to the policies involved herein, there was a lower single gross premium for all the coverage than the aggregate of what the premiums would have been for separate coverage, the overall administrative costs were lower, there was a single reserve, and the insured could not separately terminate any part of the coverage (as he or she might wish to do with respect to coverage not needed in later years) without terminating the entire policy. But this separateness does not, in our opinion, require a single characterization of the contract for the purposes of section 818(c)(2).

None of the separate elements upon which petitioner relies compels the conclusion that the preliminary term reserves for those policies cannot be segregated into portions representing each element of coverage. Indeed, petitioner's own expert admitted that it was possible to segregate the reserves into component elements of coverage and agreed that the issue before the Court was whether the segregation approach *should be adopted*.[27] To be sure, he posited his agreement as to segregation on a purely theoretical basis, testifying that there are many permutations and combinations of segregation for any given policy. The fact that a variety of theoretical approaches may be possible does not mean that we cannot segregate the facially discernible term and permanent components of the coverage provided by the actual policies involved herein. Indeed our own concern for not permitting theory to dictate the results which should obtain in real situations causes us to reject the contention, which respondent appears to embrace, that we should go behind the coverage facially discernible in decreasing (or increasing) term policies so as to eliminate from the adjustments under subparagraph (B) that

[26] In this situation, if the foundation of the policy, i.e., the permanent coverage, were to be terminated, the entire policy would be terminated.

[27] Petitioner in fact made such a segregation, reporting portions of the contracts in issue as term insurance on its annual statements and tax returns for the years in issue. Petitioner, in the stipulation of facts by the parties, takes the position that such treatment was in error. While we do not consider such treatment by petitioner an admission, and respondent does not argue to the contrary, we note that petitioner's reporting for the years in issue, as well as the agreement by both parties at trial that segmenting the contracts is possible, if not desirable, casts serious doubt on the impossibility of segregating the contracts.

portion of the coverage which represents coverage having a term of 15 years or less.[28]

We conclude that respondent's position is essentially correct and that the components of the policies in issue herein representing term life insurance and those representing life insurance "other than term" should be segregated for the purpose of applying section 818(c)(2).[29] In definitional terms, this means determining the coverage facially discernible from each of the policies in issue which expires at a fixed point in time other than the insured's death, i.e., term insurance, and that payable on the death of the insured whenever that occurs, i.e., "other than term," or permanent, insurance. See *Lincoln National Life Insurance Co. v. United States*, 217 Ct. Cl. 515, 582 F.2d 579, 590 (1978); D. McGill, Life Insurance 44 (rev. ed. 1967); S. Huebner & K. Black, Life Insurance 67 (10th ed. 1982); D. Gregg & V. Lucas, Life and Health Insurance Handbook 55 (3d ed. 1973).

Our opinion thus far furnishes a clear direction to the parties for answering the first two of the four previously articulated elements, see *supra* p. 542, involved in the application of section 818(c)(2)(A) and (B). One additional task remains

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[28]Thus, respondent's expert testified that a 20-year term insurance policy providing coverage in the amount of $1,000 decreasing at a rate of $50 per year should be viewed in layers—a 1-year term policy for $1,000 plus a 2-year term policy for $950 plus a 3-year term policy for $900, etc. Under this view, the only insurance covering a period of more than 15 years, i.e., qualifying under sec. 818(c)(2)(B), is in the amount of $250, and that amount decreases by $50 per year during years 16–20. While this may be a valid theoretical approach, we see a material distinction between (1) segregating facially discernible term coverage from facially discernible permanent coverage as such and (2) layering the amounts of coverage within what is on its face one term insurance policy. When the amount of coverage fluctuates depending on the policy year of death, such fluctuation is incompatible with the concept of permanent insurance, which by definition provides a death benefit payable regardless of the date of death. See D. McGill, Life Insurance 58 (rev. ed. 1967); S. Huebner & K. Black, Life Insurance 77 (10th ed. 1982). However, there is nothing sufficiently unusual or antithetical about increasing or decreasing term insurance policies to require a further segregation of such policies by amount into their theoretical component layers. See D. McGill, *supra* at 51–52; D. Gregg & V. Lucas, Life and Health Insurance Handbook 56–57 (3d ed. 1973). Similarly, while it may be theoretically valid to view pure permanent insurance, i.e., insurance featuring level gross premiums and a level death benefit, as term insurance for a term consisting of the mortality period of the insured with an increasing investment element, it is inconceivable that this kind of policy would not be eligible for the adjustments under subparagraph (A). Compare D. McGill, *supra* at 38, and D. Gregg & V. Lucas, *supra* at 69–70, with S. Huebner & K. Black, *supra* at 79.

[29]We note that our holding in *Moseley v. Commissioner*, 72 T.C. 183 (1979), urged by petitioner as dispositive on this issue, has no bearing on the instant case. In *Moseley*, we dealt with the taxability under sec. 72 of insurance proceeds, part of which were attributable to a special reserve built up with a portion of the gross premiums paid. Despite the fact that, due to investment gains by the fund, the proceeds exceeded the aggregate premiums credited to the special reserve, we held the proceeds to be a nontaxable recovery of premiums. Such holding has no relevance to the question whether contracts must be segmented into components under sec. 818(c)(2).

before we analyze the individual policy plans involved herein. Some further comment is required in order to calculate the amount of insurance to which the $21 or $5 per thousand applies (the third element) and the amount of reserves to which the percentages decreases in subparagraph (A) or (B) apply (the fourth element). As to the third element, we have rejected the layering process suggested by respondent's expert witness. See *supra* p. 548 & note 28. Accordingly, as to that element, the amount of each facially discernible component of coverage in force in each taxable year in issue under a particular policy should be taken into account in applying $21 or $5 per thousand, as the case may be. With respect to the fourth element, we hold that the calculation should be made by allocating the reserve for each policy based upon the reserves which would have been set aside if each component had been sold separately. We recognize that the parties have stipulated that petitioner did not in fact sell the components separately, but this should not be an insurmountable obstacle to the aforementioned allocation; as we understand it, the calculation of reserves is based not upon the gross premium charged, but rather upon the amount that should be set aside based upon mortality and interest rates specified by the appropriate insurance authorities. Thus, a calculation of the proper reserve for each component can be made. Neither does the fact that, as petitioner's expert testified, the sum of these component reserves may be more than petitioner's actual reserves constitute an obstacle to such allocation. The portion of petitioner's single reserve allocable to a particular component should be that proportion of petitioner's actual reserve which the reserve for that component, calculated as if it had been sold separately, bears to the sum of the reserves for all the components, calculated as if they had been sold separately.[30]

It now remains to be determined whether petitioner's contracts issued under policy plans P8, P9, O1, OO, and OL are, within the meaning of section 818(c)(2), "other than term insurance," "term insurance under such contracts which at the time of issuance cover a period of more than 15 years," or

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[30]The denominator of this ratio should include the separate reserve so calculated in respect of coverage for a term of 15 years or less, which is not eligible for the adjustments provided in subpar. (B).

neither. Contracts under plans P8 and P9 provide for payment of the Face Amount at death, an Additional Death Benefit if death occurs prior to the end of the 15th policy year, and a Return of Premium Death Benefit if death occurs prior to the earlier of the end of the 20th policy year or age 65. Under the standards we have established, the Face Amount is covered by section 818(c)(2)(A). The Additional Death Benefit, which is payable only during a period of 15 years or less, does not qualify under section 818(c)(2)(A) or (B). Similarly, if, based upon the insured's age at date of issuance, the Return of Premium Death Benefit is not payable beyond 15 years from the date of the issuance of the policy, that benefit will not be covered by either section 818(c)(2)(A) or (B). Otherwise, the Return of Premium Death Benefit will be covered by section 818(c)(2)(B), but in the amount actually in force in any given taxable year. See discussion of the "third element," *supra* p. 549.

Contracts under plan O1 provide for payment of the Sum Insured at death and a Return of Premium Death Benefit if death occurs prior to the end of the 20th policy year. The Sum Insured is covered by section 818(c)(2)(A), and the Return of Premium Benefit is covered by section 818(c)(2)(B), but in the amount actually in force in any given taxable year.

Contracts under plan OL provide for payment of the Amount of Insurance at death in an amount varying with the insured's age at issue and the policy year in which death occurs, pursuant to a table incorporated in each contract. A designated amount (the Ultimate Amount) is payable no matter when death occurs. Under the standards we have established, the Ultimate Amount is "other than term insurance," i.e., permanent insurance, and is covered by section 818(c)(2)(A). The remaining amount is "term insurance." Whether it is covered by section 818(c)(2)(B) depends upon whether, based upon the insured's age at the date the policy was issued, the period measured from the date of issuance to the date after which only the Ultimate Amount is payable is more than 15 years. If it is not, none of the term insurance under that policy is covered by that section. If it is, it will be covered by section 818(c)(2)(B), but in the amount actually in force in any given taxable year.

Contracts under plan OO provide for payment of the Basic Amount of Insurance at death and an Insured Annual Income Death Benefit if death occurs before age 65, both of which benefits vary in amount with the insured's age at issue and the policy year in which death occurs, pursuant to a table incorporated in each contact. Under the standards we have established, the part of the Basic Amount of Insurance which is in any event payable upon the insured's death after age 65 is covered by section 818(c)(2)(A). The balance of the Basic Amount and the full amount of the Insured Annual Income Death Benefit constitute "term insurance." Whether these amounts are covered by section 818(c)(2)(B) will depend upon whether the insured had attained age 50 as of the date the policy was issued. If he or she had, no part of said amounts under that policy will be covered by section 818(c)(2)(B), because the term at issuance involved will not be more than 15 years. If the insured was less than 50 years of age at the date of issuance, these amounts will be covered by section 818(c)(2)(B), but in the amount actually in force in any given taxable year.[31]

Issue 3

FINDINGS OF FACT

During each of the years 1971, 1972, 1973, and 1974, petitioner had in force certain individual accident and health insurance policies that are at issue in the instant case (the "renewable individual accident and health insurance policies"). Under the terms of certain of petitioner's renewable individual accident and health insurance policies, petitioner either (a) could neither cancel coverage nor refuse to renew coverage at the annual gross premium specified in the policy during the insured's life, or (b) could neither cancel coverage

[31] We recognize that, though we essentially hold for respondent on the issue of segregating combination policies into their component parts, our approach to the application of sec. 818(c)(2) to combination policies differs from the positions of both parties. Indeed, neither petitioner in its returns for the years in issue nor respondent in his statutory notice attempted to allocate petitioner's reserves among the various components of the policies' coverage or to calculate the 0.5 percent reserve reductions. However, neither party now maintains that its treatment of the reserves was correct, and the language of sec. 818(c)(2) clearly requires the reserve reductions. Our opinion, based solely on the facts stipulated to by the parties and presented at trial, merely develops the legal principles underlying sec. 818(c)(2) and establishes guidelines for the computation of the proper reserve adjustments in determining the decision to be entered under Rule 155.

nor refuse to renew coverage at the annual gross premium specified in the policy until the insured attained age 65. Under the terms of the remainder of petitioner's renewable individual accident and health insurance policies, petitioner could neither cancel coverage nor refuse to renew coverage at the annual gross premium specified in the policy until the earlier of the insured's (1) attaining age 65 or (2) becoming eligible for "Medicare." The annual gross premium payable with respect to each of petitioner's renewable individual accident and health insurance policies was level for the duration of the policy. Such annual gross premium specified in such policies was based on the insured's age at issuance. Petitioner could not change the annual gross premium specified in any of its renewable individual accident and health insurance policies as a result of changes in the insured's health or occupation, claims made by the insured under his or her policy, or increases in the insured's attained age. Under the terms of its renewable individual accident and health insurance policies, petitioner could, however, adjust annual gross premium rates by classes in accordance with its experience under such policies.

The annual gross premium petitioner charged for its renewable individual accident and health insurance policies was higher than the annual gross premium it would have charged for comparable policies provided on a cancellable basis, e.g., on a basis where petitioner could have adjusted premiums based on the insured's increasing age, changes in the insured's health or occupation, or claims made by the insured under his or her policy. Such higher annual gross premium that petitioner charged for its renewable individual accident and health insurance policies was intended to cover the additional cost inherent in petitioner's long-term obligation to renew the coverage in later years when the insured was older.

There are no differences in the terms and provisions of petitioner's renewable individual accident and health insurance policies, or in its contractual obligations thereunder, based upon how long such policies have been in force. Specifically, petitioner is contractually bound to precisely the same extent under a renewable individual accident and health insurance policy that has been in force for 2 years or less as it

is under a renewable individual accident and health insurance policy that has been in force for more than 2 years.

The insurance industry recognizes the type of insurance product called the guaranteed renewable individual accident and health insurance policy (GRAH policy). A GRAH policy generally has the following characteristics: level annual gross premiums are payable, are based on the insured's age at issuance, and do not increase as the insured grows older; the issuing company can neither cancel coverage nor refuse to renew coverage at the annual gross premium specified in the policy until a specified age, notwithstanding changes in the insured's health or occupation or claims made by the insured under the policy; and the issuing company can adjust the annual gross premium rates by classes in accordance with its experience under policies of that type. A GRAH policy thus provides the insured with the benefit of an annual gross premium rate unaffected by changes in the insured's age or health, and also enables the insurer, through its ability to change annual gross premium rates by classes, to cope with inflation and changes in health care standards affecting claim costs. Because of the long-term obligations of an issuer to renew GRAH policies and the limited circumstances in which an insurer may increase annual gross premiums under GRAH policies, insurers issuing such policies assume long-term morbidity risks that extend beyond the period for which a gross premium has been paid (the "current term" of the policy).

Each of petitioner's renewable individual accident and health insurance policies in issue here had from the date each such policy was issued the characteristics of a GRAH policy, and is considered within the insurance industry to be a GRAH policy.

With respect to the aggregate of its renewable individual accident and health insurance policies, petitioner established and held as of the end of each of the years 1971, 1972, 1973, and 1974 an active life reserve consisting of two reserve components: (1) a gross pro rata unearned premium reserve, and (2) an additional statutory life insurance reserve computed on the mid-terminal reserve basis (a mid-terminal reserve). An unearned premium reserve with respect to an insurance policy is a reserve established as of December 31 (the valuation date) to cover claims and benefits that will be incurred during

the remainder of the current term of the policy. No part of an unearned premium reserve remains at the termination of the premium payment period. A gross pro rata unearned premium reserve as of the valuation date is equal to that portion of the gross premium paid for the current term of an insurance policy which bears the same proportion to the total gross premium paid for the current term of such policy as the number of months in the unexpired current term of such policy bears to the total number of months in the current term of such policy. In computing its gross pro rata unearned premium reserve with respect to its renewable individual accident and health insurance policies as of the end of each of the years 1971, 1972, 1973, and 1974, petitioner assumed that gross premiums with respect to such policies were received at a uniform rate throughout each month or, in effect, that each gross premium was received on the 15th day of the respective month. Thus, as of December 31 of any given year, all renewable individual accident and health insurance policies issued in December were considered to have been in force for one-half month, policies issued in November were considered to have been in force for 1½ months, etc. For example, as of December 31 of any given year, the gross pro rata unearned premium reserve with respect to a renewable individual accident and health insurance policy issued in November with a current term of 1 year and an annual gross premium of $100 would be $87.50 ($87.50/$100.00 = 10.5/12).

The second component of the active life reserve established and held at the end of each of the years in issue by petitioner with respect to its renewable individual accident and health insurance policies was the additional reserve that petitioner computed with respect to such policies on the mid-terminal reserve basis. This additional or mid-terminal reserve arose from petitioner's long-term obligation to renew its policies. The purpose of the additional reserve is to cover claims and benefits that will be incurred after the end of the current term of the renewable individual accident and health insurance policies. A life insurance company typically holds an additional or mid-terminal reserve only with respect to those policies that place on the insurer a risk extending beyond the current term of the policy and for which at some point future gross premiums alone will be inadequate to pay expected claims.

The term "mid-terminal" reflects the use at the valuation date of an average figure based on the assumption that policies are sold at uniform intervals, so that all policies issued in any given calendar year may be deemed to have a mean, average, or "mid-terminal" date of July 1.

All of petitioner's renewable individual accident and health insurance policies in force at the end of each of the years in issue, regardless of whether such policies were at that time in force for 2 years or less or for more than 2 years, exposed petitioner to long-term morbidity risks arising from its long-term obligation to renew such policies, which extended beyond the current term of the policies. Because of such long-term morbidity risks, petitioner established and held at the end of each of the years 1971, 1972, 1973, and 1974 an additional or mid-terminal reserve with respect to such policies that was required to be adequate to cover its obligations on all such policies including policies in force for 2 years or less and for more than 2 years. Petitioner established and held the mid-terminal reserve with respect to its renewable individual accident and health insurance policies to cover its future contingent claims—those not yet incurred—under such policies. Such mid-terminal reserve was equal to the excess of the present value of future benefits payable under such policies over the present value of future net premiums under such policies. The mid-terminal reserve petitioner established and held at the end of each of the years 1971, 1972, 1973, and 1974 with respect to its renewable individual accident and health insurance policies was computed on the basis of (1) recognized morbidity and mortality tables within the meaning of section 801(b)(1)(A), including the 1964 Commissioners Disability Table, the 1956 Intercompany Hospital and Surgical Tables, and the 1958 Commissioners Standard Ordinary Mortality Table, (2) an assumed rate of interest of 3 percent, and (3) the 2-year preliminary term method.

The 2-year preliminary term method of computing reserves with respect to GRAH policies is a recognized actuarial method that has been accepted by the NAIC and by the pertinent regulatory agencies of all those States in which petitioner does business, including the Tennessee Department of Insurance. The 2-year preliminary term method is the method most commonly used for computing reserves on GRAH policies. Both

the Report of NAIC Task Force 4 on Valuation Standards, dated November 26, 1956, and the 1964 Report of the NAIC Industry Advisory Committee on Health Insurance Reserves recommended, inter alia, the adoption of the 2-year preliminary term method for valuing reserves held with respect to GRAH policies. The recommendations of the 1964 Report of the NAIC Industry Advisory Committee on Health Insurance Reserves were adopted by the NAIC at its December 1964 meeting and are generally recognized and accepted by all States as a suitable minimum valuation standard for GRAH policies. The 2-year preliminary term method is a recognized preliminary term method within the meaning of section 1.818–4(a), Income Tax Regs.

Mechanically, the computation on the 2-year preliminary term basis of the additional or mid-terminal reserve with respect to petitioner's renewable individual accident and health insurance contracts was, during the years here in issue, as follows: An amount was computed for its renewable individual accident and health insurance policies in force for more than 2 years as of the end of each year in issue by applying to benefits under each such policy unit reserve factors computed on the basis of the mortality and interest assumptions discussed above. The amount so computed was added to petitioner's mid-terminal reserve with respect to its renewable individual accident and health insurance contracts. When a mid-terminal reserve is calculated on the basis of the 2-year preliminary term method, such reserve with respect to a GRAH policy in force for 2 years or less would be equal to zero dollars. Therefore, the use of the 2-year preliminary term method permitted petitioner to arrive at a reserve of zero dollars with respect to its renewable individual accident and health insurance policies in force for 2 years or less as of the end of each year in issue; with respect to such policies, then, petitioner added zero to its mid-terminal reserve.

While the additional or mid-terminal reserve is mechanically developed by applying unit reserve factors to unit benefits of single policies, separate reserves are not held on single policies. Rather, the additional or mid-terminal reserve is an aggregate reserve, and has actuarial meaning only with respect to an entire group of policies. Mortality and morbidity tables are used in the calculation of unit reserve values, and

such tables assume that a large population of policyholders is expected to die or become ill according to certain yearly rates. The additional or mid-terminal reserve is an aggregate amount which, together with future net premiums, will meet the benefit payments arising from the group of policies valued as such benefits accrue in the future. The application of a formula for the calculation of such reserve to an individual policy (or small group of policies) does not produce a meaningful result, since few policyholders will experience average morbidity.

The annual statement filed by petitioner with the Tennessee Department of Insurance for each of the years 1971, 1972, 1973, and 1974 included an exhibit labeled "Exhibit 9 - Aggregate Reserve for Accident & Health Policies." Exhibit 9 of the annual statement was subdivided into section A (exhibit 9A), the Active Life Reserve section, and section B, the Claim Reserve section. The first line of exhibit 9A was labeled "Unearned premium reserve." The second line of exhibit 9A was labeled "Additional reserves." The entry on line 1 of exhibit 9A of petitioner's annual statements for each of the years 1971, 1972, 1973, and 1974 included the gross pro rata unearned premium reserve that petitioner established and held with respect to its renewable individual accident and health insurance policies. The entry on line 2 of exhibit 9A of petitioner's annual statements for each of the years 1971, 1972, 1973, and 1974 included the additional or mid-terminal reserve that petitioner established and held with respect to its renewable individual accident and health insurance policies.

For each of the years 1971, 1972, 1973, and 1974, the reserve with respect to petitioner's renewable individual accident and health insurance policies that petitioner valued and reported in its annual statements was accepted by the Tennessee Department of Insurance as held for the fulfillment of the claims of policyholders or beneficiaries of such policies. Once petitioner's reserve with respect to its renewable individual accident and health insurance policies was, as described above, established and reported in its annual statements to the Tennessee Department of Insurance, petitioner was required by Tennessee statutory provisions and by the rules and regulations of the Tennessee Department of Insurance to maintain such reserve on such basis and not to reduce or

"weaken" such reserve by changing such basis without the approval of the department. Since, as is the case with the general account assets of any insurance company, there is no specific identification or segregation by petitioner of certain of its assets to support certain of its reserves, any asset of petitioner is available to pay claims of policyholders or beneficiaries of insurance or annuity contracts issued by petitioner.

On its tax return for each of the years 1971, 1972, 1973, 1974, petitioner did not revalue under section 818(c) the additional or mid-terminal reserve computed on a recognized preliminary term basis that it held with respect to its renewable individual accident and health insurance policies. Respondent determined that petitioner's renewable individual accident and health insurance policies in force for more than 2 years as of the end of each of the years 1972, 1973, and 1974 were "guaranteed" renewable accident and health insurance policies within the meaning of section 1.801–3(d), Income Tax Regs., and he therefore revalued under section 818(c) for each such year the additional or mid-terminal reserve computed on a recognized preliminary term basis with respect to such policies. However, respondent determined that petitioner's renewable individual accident and health insurance policies in force for 2 years or less as of the end of each of the years 1971, 1972, 1973, and 1974 were not "guaranteed" renewable accident and health insurance policies within the meaning of section 1.801–3(d), *supra*, and he therefore did not revalue under section 818(c) the additional or mid-terminal reserve computed on a recognized preliminary term basis with respect to such policies.

OPINION

The issue for our decision is whether petitioner's renewable individual accident and health insurance policies that were in force for 2 years or less at the end of its taxable years 1971, 1972, 1973, and 1974 are "guaranteed renewable" accident and health insurance policies within the meaning of section 1.801–3(d), Income Tax Regs. If they are, the reserves with respect to the contracts issued under such policies are eligible for revaluation under section 818(c).

Section 1.801–3(d), Income Tax Regs., provides, in relevant part—

> The term "guaranteed renewable life, health, and accident insurance policy" means a health and accident contract, or a health and accident contract combined with a life insurance or annuity contract, which is not cancellable by the company but under which the company reserves the right to adjust premium rates by classes in accordance with its experience under the type of policy involved, *and with respect to which a reserve in addition to the unearned premiums (as defined in paragraph (e) of this section) must be carried to cover that obligation.* * * * [Emphasis added.]

For its renewable individual accident and health insurance policies, petitioner held an active life reserve consisting of (1) a gross pro rata unearned premium reserve, to cover claims and benefits that will be incurred during the remainder of the period for which a gross premium has been paid, and (2) an additional, mid-terminal reserve, to cover petitioner's long-term obligation to renew the policies. Petitioner calculated its mid-terminal reserve with respect to the policies in issue on the basis of the 2-year preliminary method.

Respondent contends that the policies in issue that were in force for 2 years or less at the time of the reserve computations for the years in issue do not qualify under section 1.801–3(d), *supra*, as the 2-year preliminary term method necessarily results in a mid-terminal reserve with respect to a policy in force for 2 years or less of zero dollars. Thus, according to respondent, no "reserve in addition to the unearned premiums * * * must be carried" for the policies in force 2 years or less, and section 1.801–3(d), *supra*, is not satisfied.

This Court, in two recent Court-reviewed opinions, decided precisely this issue in favor of the taxpayers. *National States Insurance Co. v. Commissioner*, 81 T.C. 325 (1983); *United Fire Insurance Co. v. Commissioner*, 81 T.C. 368 (1983). As the parties have stipulated that the material facts of such cases are identical to those in the instant case, and that following such decisions will result in a decision for petitioner on this issue, and as we decline to review again our carefully considered decisions in *National States* and *United Fire*, we hold that the policies in issue are guaranteed renewable accident and health insurance policies within the meaning of section 1.801–3(d), *supra*.

In light of the parties' concessions and stipulations, and the foregoing opinion,

Decision will be entered under Rule 155.

ESTATE OF DOROTHY T. MEYER, DECEASED, EDWARD THOMPSON MEYER, EXECUTOR, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 17445-84. Filed April 1, 1985.

Held: Tax Court has no jurisdiction over R's determination disallowing P's election under sec. 6166, I.R.C. 1954, as amended, to pay estate tax in installments. Such determination is divorced from determination of P's entitlement to deduction for administration expense of interest.

Karen Schwaller and *Carter Bledsoe*, for the petitioner.
Cynthia J. Mattson, for the respondent.

OPINION

CANTREL, *Special Trial Judge*: This case is before the Court on respondent's motion to dismiss for lack of jurisdiction and to strike as to the payment of Federal estate tax under sec. 6166, I.R.C. 1954,[1] filed on July 23, 1984. This motion was called for hearing at the motions session of the Court at Washington, D.C., on January 16, 1985.[2] Counsel for petitioners and respondent appeared and presented argument.

Respondent, in his notice of deficiency dated March 14, 1984, determined an estate tax deficiency of $1,276,569.47. This deficiency is based in part upon an increased valuation of stock in Meyer Products, Inc. Respondent also disallowed a deduction claimed under section 2053 for an administration expense for interest on Federal estate tax, payment of which petitioner elected to defer under section 6166 (alternate extension of time for payment of estate tax where estate consists largely of

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[1] All section references are to the Internal Revenue Code of 1954 as amended.
[2] This case was assigned pursuant to Delegation Order No. 8 of this Court, 81 T.C. XXV (1983).

interest in closely held business). The disallowance of the interest deduction resulted in a $188,411 increase to the taxable estate.

In the estate's petition, timely filed on June 7, 1984, the estate alleged as error at paragraph 4(c) respondent's disallowance under section 2053 of "the administration expense shown on the estate tax return as interest on federal estate tax deferred under section 6166." At paragraphs 4(d) and 5(d) petitioner claims as follows:

> The Commissioner erred in determining that the decedent's estate was not entitled to an election under section 6166 of the Internal Revenue Code.
>
> * * * * * * *
>
> As indicated Petitioner has made a timely election to defer payment of federal estate tax under section 6166 of the Internal Revenue Code. All of the statutory qualifications pertinent to the validity of such an election are met in the present case. In particular, MPI, Inc. [Meyer Products, Inc.] was carrying on a trade or business at the date of decedent's death.

Respondent filed the motion we herein consider to strike paragraphs 4(d) and 5(d) and to dismiss the portions of this case relating to the deferred payment of Federal estate tax. Respondent relies on *Estate of Sherrod v. Commissioner*, 82 T.C. 523, 536–537 (1984), where we held that the Tax Court has no jurisdiction to decide the propriety of a denial of an election to pay the estate tax in installments inasmuch as the denial is not attributable to a deficiency.[3]

We grapple with the problem of whether we have jurisdiction over an amount of tax liability owed as a result of respondent's denial of a section 6166 election.[4] No other case that we have found deals with this precise issue, but an analysis of some of our opinions leads us to conclude that petitioner's reasoning is faulty and will not prevail here.

The parties agree that respondent determined a deficiency in part based upon his denial of petitioner's administration expense deduction. The taxable estate was increased by $188,411 and the tax on that increase produced a deficiency.

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[3] In other words, the denial of such an election "does not create, or affect the amount of, a deficiency." *Estate of Sherrod v. Commissioner*, 82 T.C. 523, 536–537 (1984).

[4] As Judge Tietjens observed in his dissent in *Estate of Bahr v. Commissioner*, 68 T.C. 74, 83 (1977), Court reviewed, "The issue seems a simple one (but it isn't)."

Petitioner contends that the denial of the section 6166 election is tied to the disallowance of the administration expense deduction for interest. According to petitioner, because the deficiency in part arises from the denial of the section 6166 election, the Court has jurisdiction to review denial of that election.

Respondent views the section 6166 election as a matter that is separate from the deficiency. Respondent argues that the determination as to whether the estate qualifies for the payment of estate tax in installments does not create, nor will it affect, the amount of the deficiency in this case. According to respondent, this Court does not have jurisdiction to review respondent's denial of the section 6166 election, but does have jurisdiction to determine the correct amount of the deduction for interest, if any. For the reasons we discuss below, we agree with respondent and grant his motion to strike and to dismiss the petition insofar as it relates to the denial of petitioner's section 6166 election.

We begin our analysis with the rule that this Court *lacks* jurisdiction over the section 6166 election determination made by respondent. *Estate of Sherrod v. Commissioner, supra.* We reiterate what this Court has oft stated in the past: our jurisdiction is limited by statute and we have no authority to enlarge upon that jurisdiction. *Estate of Sherrod v. Commissioner, supra* at 536; *Estate of Young v. Commissioner*, 81 T.C. 879, 881 (1983), and cases cited therein; *Breman v. Commissioner*, 66 T.C. 61, 66 (1976). Sections 7442 and 6213 confer jurisdiction on the Tax Court to redetermine deficiencies in income, estate and gift taxes, and certain excise taxes. See also secs. 6211–6212 and 6214–6215.

In *Estate of Sherrod*, respondent determined in the notice of deficiency that the estate did not qualify to pay the estate tax in installments pursuant to sections 6166 or 6166A. In concluding that this Court has no jurisdiction over a determination with respect to that election, the Court relied upon committee reports to proposed legislation that would have given the Tax Court such authority:

> Under present law, the decision of the Internal Revenue Service to deny an election to pay all or a portion of the estate tax attributable to closely held businesses generally is not subject to judicial review because no deficiency is involved. The committee believes that taxpayers should be

provided with a judicial forum to resolve disputes involving an estate's eligibility for the deferral of estate tax attributable to interests in closely held businesses.

* * * * * * *

In addition, the [proposed] committee bill provides a procedure for obtaining a declaratory judgment with respect to (1) an estate's eligibility for deferred payment of estate taxes attributable to an interest in a closely held business under section 6166 * * *. Jurisdiction to issue a declaratory judgment is limited to the United States Tax Court and the determination of that court is final and conclusive and is not reviewable by any other court. [H. Rept. 97-201 (1981), 1981-2 C.B. 352, 388-389.]

The proposed provision was deleted in conference. See H. Rept. 97-215 (Conf.) (1981), 1981-2 C.B. 481, 511. Thus, this Court has remained without jurisdiction to determine the eligibility of a taxpayer to make that election. See also *Estate of Williams v. Commissioner*, T.C. Memo. 1984-178. We cannot indirectly acquire such jurisdiction based upon the theory advanced by petitioner.

With regard to the interest deduction under section 2053, however, it is beyond dispute that the disallowance of this deduction produced a deficiency. Sec. 6211. This Court has jurisdiction to redetermine a deficiency in estate tax. Sec. 6213. Since respondent's determination as to whether an estate is entitled to deduct interest creates a deficiency, this Court has jurisdiction to review such a determination. See *Estate of Sherrod v. Commissioner*, 82 T.C. at 537.

The issue of whether an estate qualifies to pay its tax in installments is entirely different from the issue of whether an estate qualifies for a deduction of an administration expense. The former involves an examination of the requirements of section 6166, while the latter involves scrutiny of a totally different set of requirements and limitations under section 2053. The evidence to be presented to resolve each of these issues is different. Moreover, even if an estate does qualify to pay estate tax in installments under section 6166, it is *not* entitled to deduct as an administration expense on the initial estate return an estimate of the interest to be accrued over the deferral period. *Estate of Bailly v. Commissioner*, 81 T.C. 246 (1983). Conversely, if an estate does not qualify to pay estate tax in installments under section 6166, it may still be entitled to deduct as an administration expense an amount for interest

paid on Federal estate tax.[5] See *Estate of Bahr v. Commissioner*, 68 T.C. 74 (1977).[6]

We, therefore, conclude that (1) we have no jurisdiction to review respondent's determination as to whether petitioner can use the installment payment provision of section 6166, but (2) we do have jurisdiction to review respondent's determination as to whether petitioner qualifies for an administration expense deduction for interest. In our review, these are separate determinations by respondent and separate issues in this Court. We reject petitioner's contention that a denial of the section 6166 election is tantamount to a disallowance of the interest deduction, and its concomitant conclusion that the Court has jurisdiction to review the denial of the election.

An appropriate order will be issued.

JOHN W. SEAMAN, JR., AND BETTYE H. SEAMAN, ET AL.,[1] PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 1235-81—1239-81, 1596-81, 1598-81. Filed April 2, 1985.

Petitioners deducted their distributive shares of the losses claimed during the years in question by the Knox County Partners, Ltd., a limited partnership organized and operated for the avowed purpose of exploiting certain coal rights. The partnership's loss for 1976 was attributable to deductions for

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[5] We are mindful of the fact that in the notice of deficiency respondent disallowed the administration deduction for interest on the sole ground that "the estate does not meet the requirements of Section 6166 of the Internal Revenue Code." Respondent is not precluded, however, from raising an alternative ground for disallowance after issuing the notice of deficiency. See *Foster v. Commissioner*, 80 T.C. 34, 220 (1983), on appeal (9th Cir., Sept. 30, 1983); *Estate of Horvath v. Commissioner*, 59 T.C. 551, 555 (1973).

[6] Respondent has taken the position that an administration expense deduction for interest on Federal estate tax will be available to petitioner because, even though petitioner does not qualify under sec. 6166, there still will be interest owed on the late payment of tax and some interest has been paid by petitioner to date. The exact amount of the deduction for interest will be redetermined by this Court at a later date.

[1] Cases of the following petitioners are consolidated herewith: Bruce A. Samson and Adajean L. Samson, docket No. 1236-81; Harold G. Nix, docket No. 1237-81; Richard F. Lockey and Anne S. Lockey, docket No. 1238-81; William J. Schifino and Lois A. Schifino, docket No. 1239-81; Edward Hoornstra and Mildred Hoornstra, docket No. 1596-81; and Charles A. Kottmeier and Eloise L. Kottmeier, docket No. 1598-81.

advanced royalties, which the partnership "paid" in the form of cash and a nonrecourse note. Respondent disallowed petitioners' distributive shares of the partnership's loss for 1976. Respondent also disallowed certain of petitioners' distributive shares of the partnership's loss for 1977 attributable to the partnership's claimed deductions for accrued interest and "costs of goods—development costs." *Held*: Petitioners have not carried their burden of proving that Knox County Partners, Ltd., was organized and operated with the primary and predominant objective of realizing an economic profit. Therefore, the advanced royalties are not deductible by the partnership under sec. 162(a), I.R.C. 1954, and petitioners are not entitled to deduct their distributive shares of the claimed partnership loss for 1976. *Held, further*, respondent's disallowance of certain of petitioners' distributive shares of the partnership's loss for 1977 attributable to the partnership's claimed deduction for accrued interest is sustained, since the partnership's nonrecourse note did not constitute true indebtedness. *Held, further*, respondent's disallowance of certain of petitioners' distributive shares of the partnership's loss for 1977 attributable to the partnership's claimed deduction for "costs of goods—development costs" is sustained, since petitioners have failed to carry their burden of proving that respondent's determination with respect to the issue was erroneous.

Elliot I. Miller and *Richard S. Kestenbaum*, for the petitioners.

Patricia A. Donahue and *John Ferrante* for the respondent.

STERRETT, *Judge*: Respondent issued statutory notices of deficiency in these consolidated cases that determined deficiencies in petitioners' Federal income taxes as follows:

Docket No.	*Petitioner*	*Year*	*Deficiency*
1235–81	John W. Seaman, Jr., and Bettye H. Seaman	1976	$43,451.00
		1977	3,342.98
1236–81	Bruce A. Samson and Adajean L. Samson	1976	130,035.80
		1977	7,874.98
1237–81	Harold G. Nix	1976	43,343.00
		1977	2,624.16
1238–81	Richard F. Lockey and Anne S. Lockey	1976	29,682.70

Docket No.	*Petitioner*	*Year*	*Deficiency*
1239–81	William J. Schifino and Lois A. Schifino	1976	$28,062.70
1596–81	Edward Hoornstra and Mildred Hoornstra	1976	29,346.19
1598–81	Charles A. Kottmeier and Eloise L. Kottmeier	1976	[2]20,908.25

The ultimate issue for decision is the amount, if any, that petitioners, as limited partners, are entitled to deduct as their distributive shares of the losses claimed during the years in question by the Knox County Partners, Ltd. (the partnership). Specific issues posed by the parties include the following:

(1) Whether the coal mining activity of the partnership was an activity engaged in for profit;

(2) Whether, and if so to what extent, are the advanced royalties claimed by the partnership deductible for the 1976 taxable year;

(3) Whether petitioners in docket Nos. 1235–81, 1236–81, and 1237–81 are entitled to deduct their distributive shares of interest expense claimed by the partnership for the 1977 taxable year; and

(4) Whether petitioners in docket Nos. 1235–81, 1236–81, and 1237–81 are entitled to deduct their distributive shares of "cost of goods—development costs" claimed by the partnership for the 1977 taxable year.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts, together with the exhibits attached thereto, is incorporated herein by this reference.

All of the petitioners herein were residents of Florida at the time their petitions were filed. The income tax returns for the periods involved were filed by each of the petitioners with the

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[2]The parties in the following docketed cases have agreed to be bound by the final decision in these consolidated cases: Lewis J. Hirsch and Suzanne L. Hirsch, docket No. 13500–80; Frank N. Fleischer and Barbara C. Fleischer, docket Nos. 1234–81 and 1077–83; Stanley Rosewater and Maureen Rosewater, docket No. 1597–81; Lawrence Goodwin and Nancy Goodwin, docket No. 12541–81; Ralph S. Glover and Ruth Glover, docket No. 24583–81; Samuel S. Wexler and Charlene Wexler, docket No. 27941–81; Edward N. Hoornstra and Mildred S. Hoornstra, docket No. 20530–82; Ronald R. Willey and Luanne Willey, docket No., 27188–82; and Samuel L. Winer and Judith Winer, docket No. 29243–83.

Office of the Internal Revenue Service at Chamblee, Georgia. All of the determined deficiencies in these cases are attributable to petitioners' participation, as limited partners, in the Knox County Partners, Ltd., a limited partnership organized and operated for the avowed purpose of exploiting certain coal rights.

Knox County Partners, Ltd., was organized through the joint efforts of Ralph Musicant, Michael Glantz, Carl Anderson, and Samuel Winer. Ralph Musicant is a graduate of Northwestern University, from which he received his Bachelor of Arts degree in 1968, and of Harvard Law School, from which he received his Juris Doctorate in 1971. After he graduated from law school, Musicant practiced tax and securities law, first with a firm in Illinois and later with a firm in Florida. Subsequently, he became a vice president of acquisitions and general counsel of a real estate investment firm. He then became a visiting professor of finance at the Northwestern University Graduate School of Management. In the spring of 1976 Musicant began working, as director of real estate and assistant general counsel, for Financial Analytics Corp. (Finalco), an equipment leasing firm. Prior to that time, Musicant could boast of no background in the coal mining industry. By his own admission, his prior work history largely involved the structuring of tax shelters.

It was as an employee of Finalco that Musicant first became involved in the transactions that eventually led to this litigation. During the early summer of 1976, Musicant began to investigate the coal industry as an area for expansion by Finalco. In his efforts to learn about the industry, Musicant talked to an accountant in Florida who informed him that one Michael Glantz had been involved in the coal business. Glantz's experience in the coal industry began in 1975 or 1976 when some people he knew approached him with respect to joining them in a strip mining venture. In late August or early September 1976, Musicant contacted Glantz and set up a meeting to discuss the coal mining business. The meeting was held the following day in Finalco's offices in Vienna, Virginia, and was attended by Musicant, Jack Olmstead, who was vice president of Finalco, Glantz, and Carl Anderson. Anderson was Glantz's partner in at least one coal mining venture in Kentucky. Glantz indicated that American Coal & Coke, Inc.

(American Coal & Coke), of Nashville, Tennessee, had a substantial number of coal leases, and the parties agreed to a mutual meeting with the principals of that corporation.

Thereafter, Glantz set up the meeting with American Coal & Coke. The meeting was held at the offices of American Coal & Coke in early September 1976 and was attended by Musicant, Olmstead, Glantz, Anderson, and various officers of American Coal & Coke, Cliff E. Hooper, Reginald Keene, Raymond Rhodes, and John Ozier. During the meeting, which lasted the better part of the day, the attendees discussed such matters as the nature of American Coal & Coke's involvement in the coal mining business, the sums necessary to open up a mine, the type of mining equipment that should be used, and the manner in which a possible deal might be structured. The name "American Blue Gem Coal Co., Inc." (American Blue Gem) was mentioned in the course of the conversation as a mining corporation that performed functions for American Coal & Coke.

Shortly after the meeting in Nashville, Musicant resigned from Finalco. The reason for the resignation was a dispute with Olmstead, who allegedly wanted to cut Glantz and Anderson out of any forthcoming deal that might be reached between Finalco and American Coal & Coke. Musicant then got in touch with Glantz to inform the latter that he had resigned from Finalco. It was agreed that Musicant would join Glantz and Anderson in an effort to structure a deal with American Coal & Coke.

In early October, Musicant and Glantz flew to Nashville to meet again with the principals of American Coal & Coke for purposes of discussing a possible sublease of mineral property.[3] The lease under inquiry was known as the Detherage lease. At this juncture the property in question was described by American Coal & Coke as an approximately 2,600-acre piece of property located in Knox County, Kentucky, and containing Blue Gem coal, the highest quality coal available. It was represented that the property was worth $2 million and that it would cost $400,000 to open a mine. The parties

[3] It so happened that Olmstead was on the same flight and also had arranged a meeting with American Coal & Coke. He met separately with representatives of the corporation; however, after this point Finalco dropped out of the picture. Apparently no deal was reached between American Coal & Coke and Finalco.

pursued discussions regarding the structuring of the deal, particularly the use of an advanced royalty. Musicant believed that use of an advanced royalty would maximize the tax benefits to all participants. It was decided that the advanced royalty would be in the amount of $1,825,000. The deal agreed upon was that Glantz, Anderson, and the investors would supply the capital and that American Coal & Coke would run the business. It was contemplated that an affiliate of American Coal & Coke, American Blue Gem, would assume the role of the contract miner of the property. Unbeknownst to Musicant, and apparently Glantz and Anderson as well, American Blue Gem was not at this time an existing corporation. Musicant and Glantz explained that they would need until the end of December to raise money for the venture from outside investors. The parties, therefore, agreed to a $50,000 liquidated damages figure in the event that a sufficient number of investors could not be located by December 31, 1976.

Sometime in early October, Glantz and Anderson formed the Knox County Partners, Ltd. Glantz was the initial general partner and Anderson was the initial limited partner. Musicant was requested to prepare a limited partnership certificate and agreement. The certificate, with attached agreement, was signed and notarized on October 10, 1976. The principal place of business of the partnership was 3428 Lakewood Road, Tampa, Florida, which was Glantz's home address. American Coal & Coke also made some space available to the partnership in its offices in Nashville.

On October 15, 1976, a lease agreement was entered into between American Coal & Coke, as "lessor," and Knox County Partners, Ltd., as "lessee," entitling the lessee to mine and produce coal from the Blue Gem seams of coal on the Detherage property. The term of the lease was stated to be for such period of time as might be necessary to mine and remove the commercially minable Blue Gem seams of coal on the property. However, it was agreed that, if at any time further mining operations on the leased premises were not economically justifiable, the lessee, upon notice to the lessor and provided that the lessee was not in default on any of its obligations under the lease, could terminate the lease and preclude the accrual of any further obligations of the lessee under the lease. Under the terms of the lease, the lessee

agreed, inter alia, to submit to the lessor a plan for the course of development of the property and to submit annual reports with respect to the course of development of the mine; to commence mining operations not later than May 1, 1977; to employ a competent registered engineer to prepare surveys, maps, etc.; and to keep accurate books of account with respect to all coal mined. In addition, the lease contained the following provisions concerning the payment of royalties:

> *Royalties*: (a) LESSEE shall pay to LESSOR a minimum royalty annually throughout the term of this lease in the amount of Two Hundred Thousand ($200,000.00) dollars per annum. However, LESSOR recognizes that time will be required to commence operations and hereby agrees that such minimum royalty shall not commence until May 1, 1977 and shall be prorated based upon a full calendar year. (b) LESSEE shall pay to LESSOR a tonnage royalty on all merchantable coal mined, as follows: The sum of Two Dollars and Ten Cents ($2.10), for each net ton of 2,000 pounds of merchantable coal mined and sold.
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> * * * * * * *
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> (c) LESSEE shall pay an advance minimum royalty in the amount of One Million Eight Hundred Twenty-Five Thousand ($1,825,000.00) Dollars in cash and nonrecourse promissory notes on or before December 31, 1976. If LESSEE does not fulfill its obligation hereinabove, to wit, to pay LESSOR such advance minimum royalty by December 31, 1976 then LESSOR will accept such $50,000.00 as liquidated damages for LESSEE'S non-performance. Such $50,000.00 to be evidenced by LESSEE'S promissory note, Number 2, dated October 15, 1976 attached hereto.

The lease specifically stated that the royalties would be treated and considered as rent reserved for the leased premises. It was agreed that the lessor would retain a lien for such rent upon the lessee's improvements and property located on the leased premises, as well as upon the leasehold estate.

The property covered by the foregoing lease was originally leased by American Coal & Coke on September 28, 1976, from Ed Detherage, as president of White Log Jellico Coal Co., Inc. American Coal & Coke was obligated to pay Detherage a tonnage royalty of $0.70 for each net ton of 2,000 pounds of merchantable coal mined and was further obligated to pay Detherage a minimum coal royalty of $250 per month.

Subsequent to the execution of the lease agreement between Knox County Partners, Ltd., and American Coal & Coke, it was agreed between Musicant, Glantz, and Anderson that,

through his corporation, RCM Associates, Inc. (later to be known as Reserve Associates, Inc.), Musicant would join Glantz as a general partner in Knox County Partners, Ltd. In addition, there would be two more general partners, the Anderson Family Trust, of which Carl Anderson was the trustee, and Samuel L. Winer. By letter dated November 27, 1976, it was agreed that Winer would attempt to raise $600,000 from the sale of limited partnership interests in the partnership.

At the time that the lease agreement between Knox County Partners, Ltd., and American Coal & Coke was signed, no other agreements between the parties were in effect, and the partners, particularly Musicant, set themselves to the task of arranging various collateral agreements with American Coal & Coke. In addition, the partners began to do some research into the background of the corporation and the nature of the leased premises.

In the process of investigating the background of American Coal & Coke, Glantz checked with references provided by the corporation and with a "couple of miners" who were selling coal through the corporation. Those references met with Glantz's satisfaction. However, he did not verify the résumés of the corporate officers that were subsequently included in the partnership's offering memorandum. He also did not ask to examine any books and records or tax returns of the corporation. Furthermore, he never attempted to determine whether there were any judgments against the corporation or whether any of the corporation's assets were encumbered. The research undertaken by the partners generally revealed that the corporation was not as strong as it originally had appeared.

In early November 1976, Glantz, on behalf of the partnership, engaged the services of Gary R. Cummings of Cummings, Binkley & Associates, Inc., to prepare an engineering report and coal reserve estimate on the Detherage tract. Cummings, whose services had been recommended by Cliff Hooper of American Coal & Coke, was a surveyor, but he was not a mining engineer. The report estimated the existence of approximately 7,444,286 tons of Blue Gem coal on the acreage purportedly leased (approximately 2,600 acres), of which 5,211,000 tons were estimated to be recoverable by deep

mining, using a 70-percent recovery factor. The report specifically stated that "Inasmuch as the coal reserves are estimated, it is recommended that core drilling as per standard procedure be utilized to verify and prove the reserves."

On December 1, 1976, the charter of American Blue Gem was registered and certified by the State of Tennesse. Apparently, the initial shareholders of the corporation were Hooper, Keene, Rhodes, and Ozier of American Coal & Coke. At least one, if not all, of the general partners was unaware of the fact that American Blue Gem was a newly formed entity.

By a private placement memorandum (offering memorandum), dated December 2, 1976, Knox County Partners, Ltd., sought subscriptions for a maximum of 20-limited-partnership units at $30,000 per unit. It was noted that of the proceeds of the offering, all sums would be applied toward payment of the "advanced minimum royalty," with the exception of $15,000, which would be retained as working capital. It was further noted that American Coal & Coke would pay $185,000 of the $585,000 cash portion of the advanced royalty to the general partners as a consulting fee.

The offering memorandum informed potential investors that the partnership had executed a sublease with American Coal & Coke, pursuant to which the partnership had obtained the coal rights to mine the Blue Gem seam of coal on the approximately 2,600 acres covered by the sublease. It further informed investors that the sublease called for a $200,000-per-year minimum royalty and that $1,825,000 of the "advanced minimum royalty" would be paid on the closing date, $585,000 in cash and $1,240,000 by the execution of a nonrecourse note. The note, which was to bear interest at the rate of 6-percent per annum, would be dated the closing date and would be due May 1, 1986. Principal and interest payments were to be paid quarterly. The offering memorandum explained that the note would be wholly without recourse to any partner and that the sole remedy of American Coal & Coke in the event of default was to terminate the sublease. Recoupment of the "advanced minimum royalty" of $1,825,000 was to occur at the rate of $2 per ton of coal mined and sold and was to continue until 912,500 tons had been mined and sold.

The offering memorandum also described the general nature of the mining contract that the partnership would

execute with American Blue Gem as contract miner of the leased premises. The memorandum stated that American Coal & Coke and American Blue Gem, in conjunction, would determine the type of mining equipment to be used on the premises. It was represented that American Blue Gem would guarantee the mining of 100,000 tons per year and that the partnership, in turn, would pay American Blue Gem a base price of $17 per ton for each ton mined and sold. The base price was subject to escalation. It was further represented that, in the event that American Blue Gem was unable to satisfy its guarantee to mine 100,000 tons per year, thereby resulting in the partnership's inability to pay the portion of the advanced royalty represented by the nonrecourse note, American Blue Gem would be obligated to pay the partnership liquidated damages in an amount sufficient to amortize the note. It was specifically contemplated that the liquidated damages could be paid in the form of promissory notes executed by American Blue Gem, and it was represented that American Coal & Coke had agreed to accept such notes in lieu of any payments to be applied as credits against the partnership's note to American Coal & Coke.

The offering memorandum set forth a substantial number of risk factors inherent in the investment. It was noted that there could be no assurances made with respect to the coal reserves; that coal prices had peaked in 1974 and 1975 and had declined since that time; that the general partners had little experience in the operation of a coal mining business; that certain potential conflicts of interest existed; and that there was no assurance that the contract cost of American Blue Gem's services would be maintained at the initial contract price and no assurance that American Blue Gem would be financially responsible with respect to its guarantee.

A substantial portion of the offering memorandum was devoted to a discussion of the tax aspects of the transaction. In addition, a generally favorable tax opinion prepared by Robert M. Levin, Esq., was attached to the offering memorandum. Levin was a friend of Musicant's, with whom Musicant shared office space upon his return to Chicago, after leaving the employ of Finalco. The offering memorandum noted that there were substantial tax risks associated with an investment in the partnership and cautioned that "Since so-called 'tax

shelters' are generally under attack by the Internal Revenue Service, it is reasonable to expect that upon an audit, the Internal Revenue Service may differ with legal Counsel in the application of the Internal Revenue Code to the Partnership."

In addition to the tax opinion, various other exhibits were attached to the offering memorandum, including, for example, a copy of the amended and restated partnership agreement, financial projections prepared by Musicant from information provided by American Coal & Coke, the engineering report and coal reserve estimate prepared by Cummings, and résumés of the principals of American Coal & Coke and American Blue Gem.

On December 2, 1976, the partnership, American Coal & Coke, American Blue Gem, and American Coal & Coke's attorney, as escrow agent, entered into an escrow agreement, whereby the parties agreed to deposit with the escrow agent executed copies of a coal mining agreement between the partnership and American Blue Gem, coal brokerage and coal purchase agreements between the partnership and American Coal & Coke, and a joint agreement between the partnership, American Coal & Coke, and American Blue Gem. These documents were to be released to the parties upon the receipt by American Coal & Coke of the advanced royalty payment called for by the lease agreement dated October 15, 1976. The documents were to be of no force and effect in the event that the advanced royalty payment was not made on or before December 31, 1976.

As contemplated in the offering memorandum, pursuant to the terms of the executed mining agreement, American Blue Gem guaranteed that it would mine or cause to be mined a minimum of 100,000 tons of coal per year, beginning May 1, 1977, and continuing throughout the term of the agreement. In return, the partnership agreed to pay American Blue Gem, subject to adjustments, the sum of $17 for each ton of coal so mined. The term of the agreement was to be for an initial period of 10 years and could thereafter be extended at the option of American Blue Gem. However, if either party failed to perform any of its obligations set forth in the agreement, the nondefaulting party was granted the right to terminate the agreement.

The agreement jointly executed by the partnership, American Coal & Coke, and American Blue Gem elaborated on the latter corporation's minimum mining guarantee and set forth the following provisions with respect to the payment of liquidated damages on the failure to satisfy the guarantee:

> If the Miner [American Blue Gem] in any month after May 1, 1977, should fail to mine coal under the Mining Contract for any reason other than as may be set forth in paragraph 12 (the Force Majeure provision) of the Mining Contract, it shall pay to the Lessee [Knox County Partners, Ltd.] as liquidated damages for such failure the sum of $16,666 on the last day of such month.
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> * * * Payments which may be required of the Miner under paragraphs 1 and 2 hereof to the Lessee may be made at the election of the Miner in either cash or non-interest bearing negotiable promissory notes payable to the Lessor (American Coal & Coke, Inc.).
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> * * * The Lessor by the execution hereof agrees to accept from the Lessee without recourse any promissory notes received by Lessee from the Miner pursuant to this Agreement and Lessor shall apply such promissory notes as credits against the Lessee's obligations under the Lease and Note.

Pursuant to the coal brokerage agreement executed on December 2, 1976, the partnership appointed American Coal & Coke as its exclusive agent for the sale of coal. The corporation would receive an escalating commission for its brokerage services, the amount of which was dependent upon the amount of the gross proceeds from coal sales. Pursuant to the coal purchase agreement also executed on December 2, 1976, the partnership generally agreed to sell, and American Coal & Coke generally agreed to buy, 75,000 net tons of coal per year at a price of $21.50 per net ton for a period of 2 years.

At some time after the offering memorandum was prepared and the escrow agreement signed, the partnership had a title report prepared on the Detherage tract. That report disclosed a problem with respect to the title on over 1,000 acres of the land. At that juncture, the partners presented the matter to Chicago Title Insurance Co. and were able to obtain a title insurance policy with respect to 1,100 acres of the Detherage tract. After he learned of the title defect on the Detherage tract, Musicant approached American Coal & Coke and requested that an additional property be added to the lease. Thereafter, on December 28, 1976, the lease agreement was amended to add an additional property known as the Jones property. The lease was again amended on December 30, 1976,

making it clear that the royalty provisions contained in the original lease were not to apply to the Jones property. On December 31, 1976, an agreement was entered between the partnership and American Blue Gem providing that American Blue Gem had the option of extending the mining agreement of December 2, 1976, to cover the Jones property.[4]

On December 31, 1976, the partnership, American Coal & Coke, and American Blue Gem entered into an agreement whereby the former corporation agreed to loan the latter corporation the sum of $206,000 for purposes of establishing the initial mining operations on the property leased by the partnership. By the same agreement, the parties agreed that all decisions with respect to the establishment of the initial mining operations would rest solely within the discretion of American Coal & Coke or American Blue Gem. The amount of the loan of $206,000 from American Coal & Coke was almost 100 percent less than the amount originally stated by the corporation to be necessary for purposes of opening the mine.

The limited partners of the partnership were not located until sometime in December 1976, and the record fails to disclose the exact date of their entry into the partnership. However, although at least one of the general partners, Musicant, had lost faith in American Coal & Coke by the end of December, the partnership nevertheless consummated the deal with American Coal & Coke by the originally contemplated closing date, December 31, 1976. On that date, a check in the amount of $585,000 was issued by the partnership to American Coal & Coke as payment of the cash portion of the advanced royalty. In addition, the partnership executed a nonrecourse promissory note in the amount of $1,240,000, representing the balance of the advanced royalty payable on or before December 31, 1976. By its terms, the note bore interest at the rate of 6 percent per annum beginning May 1, 1977. The note provided that American Coal & Coke's sole remedy on default would be the eviction of the partnership from the subleasehold created by the lease agreement between American Coal & Coke and the partnership dated October 15, 1976, as amended. In a separate agreement dated December

[4] An undated Errata Addendum to the partnership's offering memorandum included an amended engineering and coal reserve estimate for the portion of the Detherage tract on which the partnership had secured valid title and a reserve estimate for the Jones tract.

31, 1976, the partnership granted American Coal & Coke a security interest in the partnership's leasehold interest, and American Coal & Coke agreed that the partnership would never be personally liable for any money damages in the event of default in the payment of the $1,240,000 promissory note. The entire amount of the cash and note turned over to American Coal & Coke on December 31, 1976, was intended by the partnership to represent a royalty payment and no portion of the total was allocable to a turnkey agreement.

Subsequent to the consummation of the transaction, Glantz and Anderson assumed certain operational responsibilities. Glantz apparently undertook to make certain that American Blue Gem complied with certain legal requirements with respect to the licensing of the mine.[5] In addition, he participated in locating a Wilcox mining machine to be used on the property. In early 1977, Glantz was informed that American Blue Gem had subcontracted the mining to a company called R & M Mining Co., which was operated by Bill Ridings and a gentleman named "Monk."

On March 31, 1977, the partnership entered into an agreement with American Coal & Coke to sublease a tract of land known as the Logan property. The partnership agreed to pay a tonnage royalty of $1.35 per ton of merchantable coal mined from the property, wheelage of $0.15 per ton of coal transported across the property from other properties, and a minimum royalty of $300 per month that could be recouped against the tonnage royalty or the wheelage. The Logan tract interfaced the Detherage tract and the latter tract had to be entered through the former tract.

The results of the partnership's mining operations were unimpressive, at best. At no time was any coal mined from the Jones property. In fact, the mining equipment was never carried to that tract of property.

Mining activities began on the Detherage or Logan tract in the last week of April 1977 and continued through May 1977 or perhaps into June 1977. Some coal actually was mined from the Detherage tract, and by letter dated May 24, 1977, the following distributions from the sale of that coal were made to petitioners as limited partners:

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[5] It should be noted, however, that no licenses were made part of the record.

READEX FICHE

Petitioner	*Amount*
John W. Seaman, Jr.	$120
Bruce A. Samson	360
Harold G. Nix	120
Richard F. Lockey	80
William J. Schifino	80
Edward Hoornstra	60
Charles A. Kottmeier	60

These distributions were premature and no further distributions were ever made. In fact, at the time the distributions were made, mining operations already had been plagued with a number of problems. To begin with, initial progress was impeded by a harsh winter. In addition, difficult mining conditions were encountered at the mine opening, further slowing progress. Other problems also were encountered at the Detherage mine. The coal was dirty and had substantial impurities and a high sulphur content. The coal that was removed did not come out in lumps but rather as fines, a condition that results in a substantially reduced selling price. The crowning blow apparently occurred about a month after the commencement of mining activities, in late May or early June when difficulties with roof conditions in the mine were encountered. It was determined that the Wilcox mining equipment could not operate within the mine. At this point, efforts to continue mining the Detherage property were abandoned.

On July 18, 1977, the partnership and American Coal & Coke entered into another sublease agreement covering property known as the Waligorski property. Thereafter, some of the mining equipment that had been located on the Detherage tract was moved to the Waligorski tract, and some coal actually was mined from the property. Eventually, however, the partnership was evicted from the Waligorski tract as the result of a dispute between American Blue Gem and Bill Waligorski, the owner of the property. The eviction apparently occurred in the late summer or early fall of 1977.

Although there is evidence of attempts to locate additional properties for mining, the record fails to reveal that the partnership ever engaged in any further actual mining activities after the eviction from the Waligorski property. The evidence indicates that total tonnage mined and sold by the

partnership throughout its existence was 6,086.415 tons, all of which was mined and sold in 1977.

By at least sometime in August 1977, there had developed a dispute between Winer and the other general partners. The partnership was in serious financial straits and Winer refused to advance additional funds to the partnership. By letter dated September 27, 1977, Winer reminded Glantz and Anderson that it had been his responsibility to raise the capital necessary to form the partnership and their responsibility to get the partnership operational. Winer felt that he had lived up to his side of the agreement, but that Glantz and Anderson had not done so. By October 20, 1977, there had been a "complete deterioration of the relationships" between Winer, on the one hand, and Glantz and Anderson, on the other, as memorialized by a letter from one of the limited partners who happened to represent Winer as an attorney.

To make matters worse, a number of the limited partners were becoming disillusioned with the general partners. By letter dated February 14, 1978, one of the limited partners, Frank N. Fleischer, on behalf of himself and four other limited partners, wrote to Glantz informing him that they had learned of an Internal Revenue Service audit of the partnership and requesting information respecting the same, as well as information respecting the current status of the partnership. According to Fleischer's letter, the limited partners had received only two reports on the activities of the partnership. It was the belief of the limited partners that Glantz was not meeting his fiduciary responsibility to the limited partners.

Glantz responded to Fleischer's letter through a series of communications to the limited partners. By letter dated February 24, 1978, Glantz informed the limited partners of the audit and requested their presence at a meeting to be held a month later for the purpose of reviewing the partnership's situation. Glantz sent another letter to the limited partners dated March 29, 1978, informing them of matters discussed at the meeting, including such matters as the relocation of the partnership mine to a new unspecified leased property, the subleasing of the partnership's Jones property to a strip miner, the need for all of the limited partners to sign an amendment to the limited partnership agreement ratifying Winer's resignation, and the status of the tax audit. The next

written correspondence from Glantz to the limited partners was dated June 30, 1978. This letter conveyed the unfortunate news that the partnership had been unable to lease the new property referred to in the letter of March 29, 1978, and that the partnership had not been able, in fact, to sublease the Jones property. In addition, the letter advised the limited partners that the partnership was continuing to prospect for suitable property and also advised the limited partners of the status of the tax audit.

The displeasure of the limited partners apparently continued to increase as time went on. By letter dated September 4, 1979, Fleischer again corresponded with Glantz, stating that a number of the limited partners were very much concerned about their investments in the partnership and further stating that they had received no information with respect to their investments for well over 2 years. By letter dated April 16, 1980, five of the limited partners reminded the general partners of their agreement to lend the partnership $15,000 in connection with the defense of the partnership's tax return and threatened to institute a fraud suit against the general partners.

By further letter dated July 24, 1981, Fleischer, on behalf of himself and four other limited partners, reminded Glantz and Musicant that it had been "some time" since the limited partners had heard from the general partners and requested information regarding any attempts, or lack thereof, to get the partnership operational. In a response letter dated August 12, 1981, Glantz advised Fleischer that the partnership had been dormant for 3 years and that the partnership had no working capital with which to evaluate and acquire additional leases.

Beginning in 1977, Glantz and Anderson became interested, as officers and/or shareholders, in the corporate entities dealing with the partnership. By February 28, 1977, Anderson was serving as vice president of American Blue Gem, and by May 1977, Glantz also was serving as vice president of American Blue Gem. According to Glantz, Anderson became an officer in American Blue Gem as a part of an overall agreement that Anderson would assist the corporation in procuring financing on the mining equipment. Further, according to Glantz, he, himself, became an officer in the corporation because he was disappointed with its operations.

Eventually, in early 1978, Glantz and Anderson purchased all the outstanding shares of American Blue Gem from Hooper, Keene, Rhodes, and Ozier. Although there is no indication that the limited partners were informed of Glantz's and Anderson's status as officers of American Blue Gem in 1977, they were informed in the latter part of March 1978 that Glantz and Anderson had purchased a controlling interest in the corporation.

In April or May 1977, Glantz became an officer of American Coal & Coke. In May 1977, a corporation known as New American Coal & Coke was formed by Hooper and Keene. At the time of its formation, or shortly thereafter, New American Coal & Coke was owned 50 percent by Glantz and Anderson. Hooper and Keene owned the other 50 percent.[6] Glantz, and apparently Anderson as well, also served as officers of New American Coal & Coke after its formation. The address of New American Coal & Coke was the same as that of American Coal & Coke (hereinafter sometimes referred to as Old American Coal & Coke), the lessor of the partnership's property. In June 1977, Old American Coal & Coke changed its name to A. C. & C., Inc., and in July 1977, New American Coal & Coke changed its name to American Coal & Coke, Inc. The relationship of Old American Coal & Coke to New American Coal & Coke is entirely unclear from the record. After New American Coal & Coke was formed, Old American Coal & Coke apparently ceased operating as a going concern. According to Glantz's recollection, New American Coal & Coke took over the physical office assets of Old American Coal & Coke, but did not assume Old American Coal & Coke's financial obligations and did not deal with Knox County Partners, Ltd. In January 1978, Glantz and Anderson purchased the other 50-percent stock ownership in New American Coal & Coke. The record fails to reveal that the limited partners were informed of Glantz's and Anderson's involvement with either Old American Coal & Coke or New American Coal & Coke.

The charter of American Blue Gem was revoked on March 12, 1979, for nonpayment of franchise tax. The charter of New American Coal & Coke was revoked on August 15, 1979, for nonpayment of franchise tax. The charter of Old American

[6] The other 50 percent of the stock actually may have been held by Hooper's and Keene's wives or family trusts set up by them.

Coal & Coke was revoked on April 14, 1981, for nonpayment of franchise tax.

The Knox County Partners, Ltd., opened a bank account at the National Bank in St. Petersburg, Florida. That account was closed in October 1979. The partnership maintained another account at the Third National Bank in Nashville, Tennessee. The partnership used the address of American Coal & Coke for its bank account with the Third National Bank. Some of the checks written on this account were signed by James D. Perry, accountant for American Coal & Coke, and Hooper's wife. The partnership maintained yet another account with American Fidelity Bank & Trust Co., in Barbourville, Kentucky. The partnership used American Coal & Coke's address for this account, as well.

During 1977, the books and records of Knox County Partners, Ltd., were kept by Perry, who did not receive a fee from the partnership with respect to his bookkeeping services. Perry was given authority to sign checks using a signature machine with Glantz's signature as an imprint.

Knox County Partners, Ltd., used the accrual method of accounting. The partnership returns of the Knox County Partners, Ltd., reveal the following:

Year	*Gross receipts*	*Cost of goods sold*	*Interest deduction*	*Other income*	*Other deductions*	*Ordinary income (loss)*
1976	- - -	- - -	- - -	- - -	$1,825,000	($1,825,000)
1977	$95,545	$200,305	$49,207	$99,977	37,129	(91,119)
1978	- - -	- - -	86,675	199,992	5,091	108,226
1979	- - -	- - -	70,910	199,992	2,368	126,714
1980	- - -	- - -	66,138	199,992	1,739	132,115
1981	- - -	- - -	56,768	199,992	30	143,194
1982	- - -	- - -	52,064	199,992	- - -	147,928

The interest deductions were attributable to the $1,240,000 nonrecourse note delivered by the partnership to American Coal & Coke on December 31, 1976. There is no evidence that any interest actually ever was paid on the note.

The "other income" reported by the partnership constitutes so-called "mining penalty income," the "liquidated damages" arising out of American Blue Gem's failure to satisfy its minimum mining guarantee. Two notes, each entitled "Negotiable Promissory Note" (hereinafter referred to as mining penalty notes), were executed sometime in April 1979. One

was dated December 31, 1977, and the other was dated December 31, 1978. These notes were intended to evidence transactions that were to have occurred at the end of 1977 and 1978. Pursuant to the notes, American Blue Gem promised to pay Knox County Partners, Ltd., $99,976.90 with interest at the rate of 6 percent per annum, in the case of the note dated December 31, 1977, and $199,920 with interest at the rate of 6 percent per annum, in the case of the note dated December 31, 1978. The notes were signed by Glantz as the authorized officer of American Blue Gem. Glantz did not personally guarantee the notes from American Blue Gem to Knox County Partners, Ltd. The mining penalty notes were then endorsed by Musicant on behalf of Reserve Associates, Inc., as a general partner of Knox County Partners, Ltd., and assigned to American Coal & Coke in satisfaction of the principal and interest payable on the partnership's $1,240,000 note. Glantz, in turn and on behalf of American Coal & Coke, accepted the assignment in satisfaction of the partnership obligation under the $1,240,000 note. The mining penalty notes never actually were paid. In fact, it never was contemplated that they actually would be paid. No further promissory notes were executed to evidence American Blue Gem's minimum mining commitment. For 1979 and thereafter, amortization of the partnership's note via the liquidated damages allegedly was accomplished by means of some sort of journal entries. Nothing in the record suggests that actual cash payments of principal or interest on the partnership's nonrecourse note ever were made. Although the partnership's returns for 1977 through 1982 and the Schedules K-1 issued to the partners in conjunction therewith reported mining penalty income, there is nothing in the record to establish whether the partners actually reported their distributive shares of the mining penalty income through 1982.

On their 1976 and 1977 income tax returns, petitioners John W. Seaman, Jr., and Bettye H. Seaman claimed $86,688 and $1,993, respectively, as their distributive shares of the partnership's losses for those years.

On their 1976 and 1977 income tax returns, petitioners Bruce A. Samson and Adajean L. Samson claimed $260,062 and $5,982, respectively, as their distributive shares of the partnership's losses for those years.

On their 1976 and 1977 income tax returns, petitioner Harold G. Nix claimed $86,687 and $1,994, respectively, as his distributive shares of the partnership's losses for those years.

On their 1976 income tax return, petitioners Richard F. Lockey and Anne S. Lockey claimed $57,792 as their distributive share of the partnership's loss for that year.

On their 1976 income tax return, petitioners William J. Schifino and Lois A. Schifino claimed $57,792 as their distributive share of the partnership's loss for that year.

On their 1976 income tax return, petitioners Edward Hoornstra and Mildred Hoornstra claimed $43,334 as their distributive share of the partnership's loss for that year.

On their 1976 income tax return, petitioners Charles A. Kottmeier and Eloise L. Kottmeier claimed $43,343 as their distributive share of the partnership's loss for that year.

Respondent disallowed all of the foregoing losses on a variety of grounds.

OPINION

Royalty Deductions

On its 1976 partnership return, Knox County Partners, Ltd., deducted $1,825,000 as an "advance minimum royalty" and claimed an overall ordinary loss in the same amount. Respondent advances several alternative grounds to support his disallowance of petitioners' distributive shares of the partnership's loss for 1976. Respondent's primary argument, and the one most vigorously advanced, is that the partnership was not engaged in the trade or business within the meaning of section 162, I.R.C. 1954, of mining or selling coal because the mining activity of the partnership was not an activity engaged in for profit and that therefore petitioners are not entitled to any loss deductions in 1976 arising out of their status as limited partners.

Before turning to respondent's profit motive argument, alternative arguments raised with respect to the applicability of section 1.612–3(b), Income Tax Regs., as it existed either prior to amendment or thereafter, warrant a brief discussion.

Prior to its amendment in 1977, section 1.612–3(b), Income Tax Regs., read, in part, as follows:

(b) *Advanced Royalties.* (1) If the owner of an operating interest in a mineral deposit * * * is required to pay royalties on a specified number of units of such mineral * * * *annually* whether or not extracted * * * within the year, and may apply any amounts paid on account of units not extracted * * * within the year against the royalty on the mineral * * * thereafter extracted * * *

* * * * * * *

(3) The payor, at its option, may treat the advanced royalties so paid or accrued in connection with mineral property as follows:

(i) As *deductions* from gross income *for the year the advanced royalties are paid or accrued* * * *

[Emphasis added.]

In Rev. Rul. 70–20, 1970–1 C.B. 144, and particularly in Rev. Rul. 74–214, 1974–1 C.B. 148, the Service indicated that lump-sum advanced royalties were currently deductible.

By News Release IR-1687, October 29, 1976, the Service announced a proposed amendment of section 1.612–3(b)(3), Income Tax Regs., and suspended Rev. Rul. 70–20 and Rev. Rul. 74–214. With respect to the effective date of the proposed amendment, IR-1687 provided as follows:

Under the proposed amendment, the treatment of advanced royalties would be revised, effective October 29, 1976, unless the advanced royalties are required to be paid pursuant to a mineral lease which (i) was binding prior to that date upon the party who in fact pays or accrues such royalties, or (ii) was required pursuant to a written contract, to be executed by the party who in fact pays or accrues such royalties, provided that such party establishes, to the satisfaction of the Secretary or his delegate, that under all of the facts and circumstances the contract was binding upon such party prior to that date. For purposes of clause (ii) above, a contract will in no event be considered to be binding upon such party if the obligations imposed on such party prior to October 29, 1976 were not substantial or were illusory.

In December 1977, the Service issued the final version of the amended regulation, retroactive to October 29, 1976. T.D. 7523, 1978–1 C.B. 192. Respondent at that time issued Rev. Rul. 77–489, 1977–2 C.B. 177, announcing the revocation of Rev. Rul. 70–20 and Rev. Rul. 74–214.

Under section 1.612–3(b)(3), Income Tax Regs., as amended, advanced royalties generally may be deducted only in the year that the mineral product, in respect of which the advanced royalties were paid or accrued, is sold. However, the regulation recognizes an exception in the case of advanced royalties paid

or accrued "as a result of a minimum royalty provision." Under the exception, advanced minimum royalties may, at the option of the payor, be deducted in the year that they are paid or accrued. According to the regulation, a minimum royalty provision is a provision that "*requires that a substantially uniform amount of royalties be paid at least annually* either over the life of the lease or for a period of at least 20 years, in the absence of mineral production requiring payment of aggregate royalties in a greater amount." (Emphasis added.)

The parties herein disagree with respect to whether petitioners are subject to section 1.612–3(b)(3), Income Tax Regs., before amended or as amended.

Respondent argues that the partnership was not subject to a binding obligation to pay advanced royalties on or before October 29, 1976, because the obligation to pay royalties was illusory and not substantial on that date and that therefore the partnership is subject to the regulation as amended. See *Gauntt v. Commissioner*, 82 T.C. 96, 104 (1984) (holding that a limited partnership's obligations under a coal sublease were "illusory" within the meaning of IR-1687, so that the transaction was subject to the amended regulation). Respondent further argues that, even assuming that the partnership was obligated on or before October 29, 1976, the limited partners were not bound by that date and that therefore the partnership is still subject to the regulation as amended. In this connection, respondent urges us to reconsider *Elkins v. Commissioner*, 81 T.C. 669 (1983), in which we held that the "party" required to be bound by a mineral lease or a written contract prior to October 29, 1976, in order for the old regulation to continue to apply, was the partnership and not the individual limited partner. It is respondent's position that, if the partnership is subject to the amended regulation, it is not entitled to a deduction in 1976 since no coal was mined and sold in that year.

Petitioners' counter to respondent's foregoing arguments is that the partnership is clearly subject to the regulation before amendment, because the partnership was bound prior to October 29, 1976, and it is irrelevant under *Elkins v. Commissioner*, *supra*, that the limited partners were not similarly so bound on that date. It is petitioners' position that under the regulation before amendment, as interpreted by Rev. Rul.

70–20 and Rev. Rul. 74–214, the partnership is entitled to deduct the entire advanced royalty, both the cash portion and the portion represented by the nonrecourse note. Petitioners add as an aside that, even if the partnership were subject to the regulation as amended, the royalties in question meet the definition of advanced minimum royalties and thus still would be currently deductible.

We do not intend to base our decision on any of the foregoing contentions and, therefore, we need not consider them fully. However, we do note that on two separate occasions we have considered royalty arrangements structured in substantially the same manner as was employed in the instant case. See *Maddrix v. Commissioner*, 83 T.C. 613 (1984); *Estate of Blay v. Commissioner*, T.C. Memo. 1984–565. There was no dispute but that section 1.612–3(b)(3), Income Tax Regs., *as amended*, applied in those cases. In both, we held that the royalties were not paid as the result of a minimum royalty provision and that no deduction was allowable during the years in issue since no coal was sold during those years. We think it also important to note that it is exceedingly doubtful that the old regulation permitted the deduction of lump-sum advanced royalty payments. See *Redhouse v. Commissioner*, 728 F.2d 1249, 1251 (9th Cir. 1984); *Wendland v. Commissioner*, 79 T.C. 355, 385 (1982), affd. 739 F.2d 580 (11th Cir. 1984), affd. sub nom. *Redhouse v. Commissioner, supra*.[7] Such a deduction would be not only inconsistent with the language of the old regulation, specifying that the advance royalties were required to be paid "annually," but also contrary to the well-entrenched principle of tax accounting that a payment that creates an asset having a useful life that extends substantially beyond the close of the taxable year must be deducted over the years to which the payment relates. See, e.g., sec. 1.461–1(a)(2), Income Tax Regs.; *Commissioner v. Boylston Market Association*, 131 F.2d 966 (1st Cir. 1942); *Baton Coal Co. v. Commissioner*, 51 F.2d 469 (3d Cir. 1931), cert. denied 284 U.S. 674 (1931); *University Properties, Inc. v. Commissioner*, 45 T.C. 416 (1966), affd. 378 F.2d 83 (9th Cir. 1967). Accordingly, respondent properly revoked the two revenue rulings that extended coverage of the old regula-

[7] See also *Tallal v. Commissioner*, T.C. Memo. 1984–486.

tion to the payment of lump-sum advanced royalties. *Wendland v. Commissioner*, 79 T.C. at 385.

With this background in mind, we turn to address respondent's profit motive argument.

Royalties traditionally have been described as akin to rent and are deductible by the payor as a trade or business expense under section 162(a)(3). *Commissioner v. Jamison Coal & Coke Co.*, 67 F.2d 342, 344 (3d Cir. 1933); *Burnet v. Hutchinson Coal Co.*, 64 F.2d 275, 278 (4th Cir. 1933); *Ramsay v. Commissioner*, 83 T.C. 793, 810 (1984); *Surloff v. Commissioner*, 81 T.C. 210, 232 (1983). In this case, the deduction, if allowable, would be allowable to the partnership rather than directly to the partners. In order to find that the partnership's coal venture constituted the carrying on of a trade or business, we must first find that the partnership engaged in the activity with the primary and predominant purpose and objective of making a profit. *Brannen v. Commissioner*, 722 F.2d 695, 704 (11th Cir. 1984), affg. 78 T.C. 471 (1982); *Ramsay v. Commissioner*, *supra* at 810; *Surloff v. Commissioner*, *supra* at 232–233. As used in this context, "primary" means "of first importance" or "principally," and "profit" means economic profit, independent of tax savings. *Surloff v. Commissioner*, *supra* at 233. While a reasonable expectation is not required, the profit objective must be bona fide. *Fox v. Commissioner*, 80 T.C. 972, 1006 (1983), affd. without published opinion 742 F.2d 1441 (2d Cir. 1984), affd. sub nom. *Barnard v. Commissioner*, 731 F.2d 230 (4th Cir. 1984), affd. without published opinion sub nom. *Krasta v. Commissioner*, 734 F.2d 6 (3d Cir. 1984), affd. without published opinion sub nom. *Hook v. Commissioner*, 734 F.2d 5 (3d Cir. 1984).

The determination of whether the requisite objective exists is one of fact to be resolved on the basis of all of the surrounding facts and circumstances. *Ramsay v. Commissioner*, *supra* at 810; *Flowers v. Commissioner*, 80 T.C. 914, 931–932 (1983). The burden of proving the existence of the requisite objective rests with petitioners. Rule 142(a), Tax Court Rules of Practice and Procedure; *Golanty v. Commissioner*, 72 T.C. 411, 426 (1979), affd. without published opinion 647 F.2d 170 (9th Cir. 1981). Greater weight should be given to the objective facts than to mere statements of intent. Sec. 1.183–2(a), Income Tax Regs.; *Surloff v. Commissioner*, *supra* at 233;

Dreicer v. Commissioner, 78 T.C. 642, 645 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983).

In determining whether the requisite profit objective was present in the instant case, our profit objective analysis must be made at the partnership level. *Brannen v. Commissioner*, 78 T.C. at 505; *Siegel v. Commissioner*, 78 T.C. 659, 698 (1982). Therefore, we must examine the motives and objectives of the promoters and the general managers of the partnership. *Surloff v. Commissioner*, *supra* at 233.

Having examined all of the evidence, we conclude that petitioners have not carried their burden of proving that Knox County Partners, Ltd., was organized and operated with the *primary and predominant* objective of realizing an economic profit. Petitioners' case was built largely around the self-serving testimony of their two witnesses, Musicant and Glantz. Although we found those witnesses to be generally forthright and credible, and do believe that they made some commitments to getting the partnership operational, when we look behind their self-serving testimony to the objective facts, we are left with the undeniable impression that the *primary* objective behind the formation of Knox County Partners, Ltd., was to secure attractive tax writeoffs for the limited partners.

It is undisputed that Musicant had no prior experience in coal mining. He did, however, have experience in structuring tax shelters. Furthermore, petitioners' contention that Glantz and Anderson possessed considerable experience in coal mining prior to their involvement in Knox County Partners, Ltd., is not supported by the evidence. By Glantz's own admission, he first became acquainted with the coal mining industry in 1975 or 1976, when some people he knew approached him with respect to joining them in a strip mining venture. At most, the evidence suggests that the involvement of Glantz and Anderson in the coal mining business was primarily that of investors in various unsuccessful coal ventures. In addition, the offering memorandum for the Knox County Partners, Ltd., itself cautions potential investors that the general partners had little experience in operating a coal mining business.

That the primary objective behind the formation of Knox County Partners, Ltd., was to market tax shelters is evident from the very earliest planning stages. In their haste to execute all of the necessary documents in time to locate

investors interested in claiming substantial deductions for their 1976 tax years, the general partners unreasonably neglected to investigate the leased properties in a timely and responsible fashion. There is no evidence that any of the partners actually saw the Detherage tract prior to the execution of the lease on October 15, 1976. Furthermore, it was not until after the execution of the lease that Glantz engaged Cummings to prepare a report on the property. Although none of the general partners contemplated being involved in the day-to-day operations of the mine, the general partners took the risk, at the time they executed the lease that collateral agreements with respect to the mining and selling of coal would be forthcoming. The general partners merely accepted on faith the viability of American Coal & Coke and the representations made by it concerning the value and economic potential of the property. In their haste, the general partners were satisfied with putting the cart before the horse. In doing so, they failed to discover a title defect in about one-half of the leased property. Such a cursory investigation of the leased premises cannot be squared with a primary economic profit objective.

In marked contrast with the general partners' initial failure to investigate properly the background of American Coal & Coke, an entity that was destined to play an essential role in the overall transaction, and the conditions of the leased property, were the partners' diligent efforts to pin down the tax consequences to potential investors. It was determined from the very outset that, in order to maximize tax benefits, the lease would be structured using an advanced royalty. After the lease was executed, the general partners wasted no time in engaging the services of an attorney to write a tax opinion to be included in the offering memorandum. Petitioners contend that the partnership is permitted to take advantage of tax deductions provided by law without destroying the validity of its profit objective. Of course, in so contending, petitioners miss the mark. The point is that the actions of the general partners, in elevating the importance of securing tax advantages over the importance of investigating the economic viability of the venture, belie a primary economic profit objective.

It is true that, after the preliminary stages, the partners did make inquiries into the background of American Coal & Coke. However, when one considers the very substantial role that the corporation and its related corporation, American Blue Gem, were to play in the partnership's operations, it becomes apparent that the inquiries were superficial. Glantz allegedly checked a number of references; however, all of the references checked were supplied by American Coal & Coke, and Glantz admitted that he subsequently discovered that some of those references worked for American Coal & Coke or were affiliated in some manner. At no time did the general partners verify the résumés of the corporate officers or request to examine American Coal & Coke's books and records. Nor did they attempt to discover whether there were any judgments against American Coal & Coke, or whether, and if so, to what extent, the corporation's assets were encumbered. The superficiality of the investigations is revealed clearly by the general partners' subsequent discovery that American Blue Gem was not even in existence when discussions with American Coal & Coke commenced.

It is also true that the general partners engaged Cummings to prepare an engineering report and coal reserve estimate on the Detherage tract. However, they did not do so until *after* the lease was executed. Moreover, several facts call into question the general partners' good-faith reliance on Cummings' report. In the first place, the services of Cummings, who was a surveyor and not a mining engineer, were engaged at the recommendation of Cliff Hooper, one of the officers of American Coal & Coke. In the second place, Cummings' report was merely a description of the Detherage tract and an estimate of coal reserves on the property. It did not address the economic feasibility of mining coal from the Blue Gem seam. The report, however, did contain the caveat that "Inasmuch as the coal reserves are estimated, it is recommended that core drilling as per standard procedure be utilized to verify and prove the reserves." We find the failure to heed this recommendation significant.

In addition to the foregoing, the substantive correctness of Cummings' report was called into question by respondent's experts, Marilyn D. Maisano and E. D. Conaway. For example, Conaway concluded that the data in the offering memorandum

with respect to recoverable coal reserves was too optimistic and did not represent a sound basis for a profitable mining operation. According to Conaway, the in place and recoverable estimates of coal seam reserves were not documented by actual measurements, the average coal thickness used in reserve calculations was greater than could be measured, and the recovery factor of 70 percent used by Cummings was too high. Conaway's computations of probable and recoverable reserves fell far short of Cummings' computations.

It is unnecessary for us to attempt to resolve the differences between Cummings' report and Conaway's report, because such an endeavor would serve only to distract us from the crucial question of whether, regardless of the amount of recoverable reserves, Knox County Partners, Ltd., had a good-faith objective of mining and selling coal for economic profit. As we have suggested in other cases, the existence of minable seams of coal is meaningless without a thorough study of the methods that would be required to mine the coal, the equipment that would be used, the costs of such mining, and the prospects for selling any coal mined. *Surloff v. Commissioner*, 81 T.C. 210, 235 (1983).[6]

There is no evidence that the general partners prepared any meaningful study of the economic feasibility of mining coal from the various tracts of property leased from American Coal & Coke and delivering the coal to the marketplace. In preparing the financial projections included in the offering memorandum, Musicant relied substantially upon information conveyed to him by American Coal & Coke, hardly a disinterested party.

Petitioners contend that the general partners, in structuring the lease transaction, did investigate the costs of operations and took responsible steps to assure that these costs could be met. In this connection, petitioners further contend that the amount of the advanced royalty was determined by the needs of the mining operation and the commitment of American Coal & Coke to advance to American Blue Gem enough of the advanced royalty to provide for equipment and working capital adequate to open a mine. The evidence, however, in several respects, belies petitioners' contention. First, the

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[6] *Tallal v. Commissioner*, T.C. Memo. 1984-486.

general partners, in relying upon American Blue Gem's exclusive discretion to perform all of the mining operations, entrusted the future economic viability of the partnership to a corporation that was not even in existence until December 1, 1976. The record does not disclose clearly what sort of staff was employed by American Blue Gem. In fact, there is little evidence that American Blue Gem was anything other than a paper corporation, owned and controlled by the principals of American Coal & Coke. On December 31, 1976, American Coal & Coke loaned American Blue Gem $206,000 for purposes of establishing the initial mining operation. This sum was about one-half of the cost estimated by American Coal & Coke, prior to the execution of the lease, as being necessary to open the mine. The alleged reason for the decrease in assumed costs was that American Coal & Coke had recommended that less expensive mining equipment be used, which equipment, of course, subsequently proved incompatible with the conditions existing in the Detherage mine.

Furthermore, petitioners' contention that the general partners took steps to assure that the cash portion of the advanced royalty would be sufficient to provide working capital adequate to open the mine runs athwart the testimony of Glantz that he and Anderson were placed in the position of having to loan substantial sums of money to American Blue Gem to pay for equipment. Certainly, the partnership itself did not possess the wherewithal to pay the costs of mining operations, since it was seriously undercapitalized. After paying the advanced royalty, the partnership apparently retained only $15,000 as working capital.

Another indication that the primary objective behind the formation of the partnership was to secure attractive tax writeoffs for the limited partners is the disproportionately large royalty required to be paid by the partnership to American Coal & Coke. By lease dated September 28, 1976, American Coal & Coke was obligated to pay a tonnage royalty of $0.70 for each net ton of coal mined from the Detherage tract and a minimum royalty of $250 per month, or $3,000 per year. American Coal & Coke almost immediately turned around and subleased the property to the partnership, which agreed to pay a tonnage royalty of $2.10 for each net ton of coal mined and a minimum royalty of $200,000 per year. Such

a phenomenal increase in rates fairly may be described as magical and, under the facts of this case, only can be explained as a means of inflating the deductions for the limited partners. Cf. *Surloff v. Commissioner*, 81 T.C. at 235–236.[9]

We flatly reject petitioners' argument that the overvaluation was justified because the transaction negotiated with American Coal & Coke was in the nature of a turnkey contract. According to petitioners, the ancillary services and obligations to be performed by American Coal & Coke and American Blue Gem, such as developing the mine, acquiring the necessary mining equipment, and arranging for the sale of coal, were what made the property valuable. The fallacy of petitioners' argument is obvious if for no other reason than the fact that, at the time the lease was executed on October 15, 1976, obligating the partnership to pay a tonnage royalty of $2.10 and an advanced royalty of $1,825,000, no other collateral agreements had been reached with American Coal & Coke and, of course, none had been reached with American Blue Gem, since that entity did not exist at that time. Absolutely no credible evidence exists upon which we could conclude that any portion of the royalties was allocable to a turnkey contract. In fact, when questioned about what portion of the cash and note delivered to American Coal & Coke on December 31, 1976, was allocable to royalties and what portion was allocable to the alleged turnkey contract, Musicant admitted that the entire amount was allocable to royalties. Moreover, we note that, although various collateral agreements eventually were executed between the partnership, on the one hand, and American Coal & Coke or American Blue Gem, on the other, those agreements were not executed until December 2, 1976, at which time they were placed in escrow, to be destroyed in the event that the advanced royalty was not paid on or before December 31, 1976. These agreements made independent provision for compensation to be paid to American Coal & Coke or American Blue Gem for services rendered. In short, we are left with the inescapable conclusion that the royalties were grossly overstated in relation to the value of the leased property.

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[9] Cf. also *Tallal v. Commissioner*, *supra*.

In our view, the unbusinesslike and hurried manner in which the partnership's coal venture was put together clearly foreshadowed the many disasters that shortly thereafter befell the partnership. Although the partnership did engage in some mining activities, they were forced to admit defeat within less than a year after they had located the limited partners. As far as we can determine from the record, actual mining activities occurred during, at most, a total of 5 or 6 months. Moreover, total tonnage of coal mined and sold by the partnership was only 6,086.415 tons, far from an outstanding achievement when compared to the 912,500 total tonnage required to be mined and sold in order to recoup the $1,825,000 advanced royalty.

Petitioners' contention that the ultimate demise of the partnership's business was caused by *one* circumstance, the fact that the price of coal never increased, but rather stayed steady and then declined, is without merit under the facts. Moreover, this risk was specifically noted in the offering memorandum, which cautioned investors that the market price of coal had been declining since 1975.

We are not persuaded by petitioners' contentions that the general partners kept the limited partners fully advised of all developments. The majority of the written communications from the general partners were sent only after the Service had begun to audit the partnership and in response to letters from the limited partners complaining about the lack of communications and threatening to bring a fraud suit against the general partners. It is reasonable to assume that the letters were sent, not in response to any bona fide intent to keep the limited partners current on the partnership's status, but in an effort to build the record for whatever future litigation might ensue.

Respondent asserts that the corporate histories of American Coal & Coke and American Blue Gem also indicate the lack of a bona fide profit objective. We are inclined to agree with respondent that the convoluted and incestuous corporate and personal interrelationships are highly suspicious and suggest less than arm's-length dealings between the partnership, American Coal & Coke, and American Blue Gem.

The use of the large nonrecourse note, under the facts of this case, is another indication of the lack of a bona fide profit

objective, because that note was contingent, illusory, and without any real economic substance. We have indicated on numerous occasions that the existence of large nonrecourse notes in circumstances where it is unlikely that the notes will be paid is itself an indication that the primary objective of an activity is to generate tax deductions rather than to earn an economic profit. *Ramsay v. Commissioner*, 83 T.C. 793, 820 (1984); *Estate of Baron v. Commissioner*, 83 T.C. 542, 556 (1984); *Surloff v. Commissioner*, 81 T.C. at 237–238; *Flowers v. Commissioner*, 80 T.C. 914, 937 (1983).

The facts herein reveal that sometime towards the end of 1976 potential investors with incomes taxed at the rate of at least 50 percent received copies of the offering memorandum seeking subscriptions for 20 limited partnership units at $30,000 per unit. Because of the presence of the nonrecourse note, upon making a $30,000 investment, an investor claimed an immediate tax loss of $86,688. That fact, on its face, warrants some scrutiny. This is particularly true in the instant case, since it was never contemplated that the partnership would make actual cash payments on the note in the event and to the extent that the partnership failed to mine and sell coal from the property. Petitioners contend, however, that, even in the event that the partnership failed to mine and sell coal, the note nevertheless would be paid "inexorably and immutably, year after year" by the application of the "liquidated damages" owed by American Blue Gem on its failure to satisfy the minimum mining guarantee.

In our view, the arrangement for the "payment" of liquidated damages was as devoid of economic substance as was the original nonrecourse note. It was admitted at trial that it was never contemplated by the parties that the liquidated damages actually would be paid in cash. All that was necessary was for American Blue Gem to deliver its notes in "payment" of liquidated damages to the partnership, which, in turn, would endorse them over to American Coal & Coke in satisfaction of the partnership's nonrecourse note. American Coal & Coke never intended to enforce American Blue Gem's notes and, as far as the record reveals, never did so. Perhaps, in recognition of the glaring transparency of this arrangement, notes representing liquidated damages allegedly owing in 1977 and 1978 were not executed until April 1979, at which time they were

backdated. The circularity of the arrangement is apparent when one considers that Glantz signed the notes on behalf of American Blue Gem, Musicant endorsed the notes on behalf of Knox County Partners, and Glantz then again signed the notes on behalf of American Coal & Coke. In 1979, the parties, apparently recognizing the arrangement for what it was, a meaningless exchange of paper, abandoned even its form in that they did not bother to execute and endorse any additional notes. Instead, for 1979 and for each year thereafter, amortization of the partnership's nonrecourse note via the liquidated damages was allegedly accomplished by means of some sort of journal entries, which were never produced at trial. We find it somewhat difficult to understand how liquidated damages generated journal entries for 1979 and each year thereafter as alleged by petitioners, when it appears that the corporate entities involved ceased operating as going concerns in 1979 or shortly thereafter. In fact, Glantz's testimony suggested that Old American Coal & Coke ceased operating as a going concern as early as 1977, when New American Coal & Coke was formed. The fact of the matter is that no cash ever changed hands, or ever was intended to change hands, as a result of the liquidated damages arrangement. The arrangement was merely an illusory mechanism by which to reduce a debt that itself lacked any economic substance. As such, the arrangement must be ignored.

We recognize that the partnership reported on its partnership returns the liquidated damages as non-cash taxable income up until at least 1982. However, the reporting of this phantom income, alone, does not justify the conclusion that the provision for liquidated damages had economic substance in reality. Although Schedules K-1, reflecting as income the liquidated damages, were prepared up until 1982, we have no way of knowing from the record which, if any, of the partners actually took these amounts into income throughout this period. To the extent that they did so, they did so erroneously, since neither the original nonrecourse note that was allegedly amortized by the liquidated damages nor the liquidated damages, themselves, should be respected for tax purposes.[10]

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[10]We note that there was some suggestion at trial that all of the years in which petitioners allege they have reported "mining penalty income" are open tax years, and apparently protective refund claims may have been filed in some cases.

In sum, based on a review of the objective facts established in the record, we hold that petitioners have failed to carry their burden of proving that the Knox County Partners, Ltd., was organized and operated with the primary and predominant objective of realizing an economic profit. Accordingly, respondent's disallowance of petitioners' distributive shares of the partnership's loss for 1976 is sustained.[11]

Interest Deductions

On its 1977 partnership return, Knox County Partners, Ltd., deducted $49,207 as interest accrued on the $1,240,000 nonrecourse note. In his notices of deficiency to petitioners in docket Nos. 1235–81, 1236–81, and 1237–81, respondent disallowed the partnership's deduction for accrued interest on the grounds that the nonrecourse note lacked economic substance and did not represent true indebtedness. We agree with respondent's determination.

Section 163(a) provides that "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." For the deduction to be allowable, however, the indebtedness must be genuine. *Knetch v. United States*, 364 U.S. 361 (1960); *Elliott v. Commissioner*, 84 T.C. 227 (1985); *Surloff v. Commissioner*, 81 T.C. at 242; *Narver v. Commissioner*, 75 T.C. 53, 98 (1980), affd. per curiam 670 F.2d 855 (9th Cir. 1982). Whether the nonrecourse note created a bona fide debt is a question of fact, the burden of proof of which is on petitioners. Rule 142(a), Tax Court Rules of Practice and Procedure.

We have already concluded that the nonrecourse note lacked economic substance. It is readily apparent that the advance royalties called for in the note greatly exceeded the fair market value of the leasehold interest in the Detherage property. At about the same time that the partnership agreed to pay American Coal & Coke a $200,000-per-year minimum royalty, American Coal & Coke agreed to pay the owner of the property a $3,000-per-year minimum royalty. Musicant, himself, admitted that the amount of the note probably exceeded the value of the land and that the amount of the royalties was not determined on the basis of the fair market value of the

[11] Since the partnership generated no income in 1976, sec. 183(b)(2) is not applicable.

leasehold interest. According to Musicant, the amount of the note took into account the services that American Coal & Coke was to render to the partnership. However, we have already rejected petitioners' argument that the overvaluation was due to the alleged turnkey nature of the arrangement. Thus, we are left with but one conclusion—the nonrecourse indebtedness unreasonably exceeded the fair market value of the leasehold interest. In addition, while we believe it well may be that the partnership would have paid the note when, as, and if coal was mined, it is conceded that the parties never intended an actual cash payment of principal or interest if coal was not mined. Thus, in our view, the note was contingent in nature. We reject petitioners' contention that the liquidated damages arrangement cured the contingency. *Maddrix v. Commissioner*, 83 T.C. 613, 623–625 (1984); *Estate of Blay v. Commissioner*, T.C. Memo. 1984–565. As we previously noted, the liquidated damages arrangement itself was devoid of economic substance.

Since the nonrecourse note did not constitute true indebtedness by reason of its lack of economic substance, the requirement of section 163(a) that interest be paid or accrued on indebtedness is not met. Therefore, the partnership is not entitled to a deduction for accrued interest in 1977.[12]

Deductions for "Costs of Goods—Development Costs"

On its 1977 partnership return, the Knox County Partners, Ltd., deducted $200,305 for "cost of goods sold and/or operations" and $37,129 for "other deductions." The latter category of deductions, according to the partnership return, was comprised of mine development expenses ($23,800), professional fees ($5,883), travel and promotion ($5,332), license fees ($1,000), utilities ($1,000), and miscellaneous ($114). Respondent's notices of deficiency to petitioners in docket Nos. 1235–81, 1236–81, and 1237–81 state as follows: "A deduction for costs of goods—development costs in the amount of $110,457.64 claimed on the partnership return for 1977 is disallowed because the partnership has failed to establish that

[12]Petitioners argue that *Commissioner v. Tufts*, 461 U.S. 300 (1983), requires that the nonrecourse note be recognized and treated as the functional equivalent of recourse debt. However, this argument has been rejected on a number of occasions. See *Odend'hal v. Commissioner*, 748 F.2d 908, 912–913 (4th Cir. 1984), affg. 80 T.C. 588 (1983); *Elliott v. Commissioner*, 84 T.C. 227 (1985); *Fuchs v. Commissioner*, 83 T.C. 79, 102 n. 10 (1984); *Dean v. Commissioner*, 83 T.C. 56, 78 n. 10 (1984).

the claimed deduction (a) was paid, and if paid, was paid for the purpose stated, and (b) ordinary and necessary business expenses."[13] On brief, respondent contends that petitioners have not substantiated the deduction since it has not been established what expenses the deduction relates to or whether the expenses have been paid.

The record fails to so much as reveal precisely what deductions comprised the $110,457.64 disallowance. There was a passing reference at trial to alleged mining development expenditures in the amount of $37,129. Petitioners' brief does little more than cursorily discuss the matter in a paragraph as an "ancillary issue."

Since the deductions claimed by the partnership in 1977 for "cost of goods sold and/or operations" and "other deductions" total $237,434, respondent apparently allowed over one-half of the deductions claimed. However, precisely which deductions were allowed and which deductions were disallowed we cannot say based on the record before us. It was incumbent upon petitioners to enlighten the Court, since they bear the burden of proof. Under the circumstances, we must hold that they have failed to carry their burden of proof on the issue, and we must sustain respondent's disallowance of the deductions.

Decisions will be entered under Rule 155.

KINGFISHER COOPERATIVE ELEVATOR ASSOCIATION, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 5569–83. Filed April 2, 1985.

Petitioner, a local farmers' cooperative, included patronage dividends received from regional cooperatives of which it was a member in its gross income in the year of receipt. In computing its patronage dividends for its member-patrons for fiscal year 1981, petitioner allocated net income to its patrons according to their patronage during that year. Petitioner's allocation was adopted by its board of directors and ratified annually by its

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[13] The notice of deficiency to petitioners in docket No. 1236–81 actually disallows a deduction in the amount of $110,456.64, instead of $110,457.64.

members. *Held*, petitioner's allocation method was equitable considering the stability of its membership, the practicalities of the allocation, and the apparent approval of the method by its members. *Lamesa Cooperative Gin v. Commissioner*, 78 T.C. 894 (1982), followed.

Arthur E. Bryan, Jr., James L. Malone III, Don E. Graham, and *Gary C. Karch*, for the petitioner.

Charles N. Woodward, Mary E. Speirer, and *Gary L. Bloom*, for the respondent.

COHEN, *Judge*: Respondent determined a deficiency of $59,724.97 in petitioner's Federal income tax for the taxable year ended March 31, 1981, based on disallowance of part of the patronage dividend deduction[1] claimed by petitioner, a farmers' cooperative subject to the provisions of subchapter T (secs. 1381 through 1388).[2] The issue to be decided is the equitability of petitioner's allocation to its members of patronage dividends received from regional cooperatives according to its members' patronage in the year of receipt. Because "equitability" is the principle to be applied, our findings necessarily contain substantial detail. The facts, however, are essentially undisputed.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Petitioner, a local marketing and supply cooperative association organized and incorporated under the Oklahoma Cooperative Marketing Association Act, had its principal place of business in Kingfisher, Oklahoma, at the time it filed its petition herein. Petitioner filed a Federal corporate income tax return on an accrual basis as a nonexempt cooperative for its fiscal year ended March 31, 1981.[3]

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[1] Patronage dividends are referred to herein as deductions for convenience only, without regard to whether technically they should be characterized as deductions or exclusions. See sec. 1.1382-1(a), Income Tax Regs.

[2] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the year in issue.

[3] Certain farmers' cooperatives are tax exempt under sec. 521, except as otherwise provided in subch. T.

At all times relevant to this case, petitioner was engaged in the business of marketing and storing grain, selling agricultural supplies, including feed, fertilizer, and other products, and providing storage facilities and services to its members and nonmembers. Petitioner served a geographic area extending approximately 20 miles north, south, and east, and approximately 35 miles west, of Kingfisher, Oklahoma.

Petitioner's Membership and Operations

Under petitioner's bylaws, in effect during the year in issue, membership in the cooperative was open to any producer of agricultural products handled by or through petitioner, who resided, farmed, or owned land in any territory served by petitioner, who agreed to comply with petitioner's bylaws, and who purchased the par value of 1 share of petitioner's capital stock. Membership was subject to the approval of an applicant's written application by petitioner's board of directors. Generally, each member was entitled to one vote, irrespective of the number of shares held, subject to certain exceptions for jointly held stock and votes to change the authorized capital stock.

Petitioner's business activities were managed by its board of directors. The board was composed of five members who were elected to staggered 3-year terms by the members at annual membership meetings. Candidates for vacancies on the board were selected by an independent nominating committee that attempted to select active members who were committed to petitioner and the cooperative way of doing business. The committee made an effort to select nominees so as to insure geographic diversity on the board over the area serviced by petitioner. Petitioner's directors maintained frequent informal contacts with the members in their areas. The directors were actively involved in the computation of petitioner's patronage dividends and were aware of how regional patronage dividends entered into the computation.

Petitioner's membership grew considerably after its founding in 1934 with 48 original stockholders. Ordinarily, once a farmer became a member-patron of petitioner, he maintained his membership until he retired or died, at which time other family members often took over the farming operation and continued membership in petitioner.

The amount of patronage for each member varied each year depending on crop conditions and price considerations. Petitioner's membership, however, remained relatively stable. Petitioner's membership turnover for fiscal years 1979, 1980, and 1981 was as follows:

	FY 1979	*FY 1980*	*FY 1981*
Membership on Apr. 1	1,125	1,131	1,142
Add: New members	59	49	54
Less: Terminated members	53	38	39
Membership on Mar. 31	1,131	1,142	1,157

The percentages of members terminating their membership for the fiscal years 1979, 1980, and 1981 were 4.7 percent, 3.4 percent, and 3.4 percent, respectively. Most of the terminations were the result of the retirement or death of a member.

At all relevant times, petitioner was a member of four cooperatives from which it received services, financing, and farm supplies, and through which it marketed products and rendered services. Among these cooperatives were Union Equity Cooperative Exchange (Union Equity), a regional grain marketing cooperative of Enid, Oklahoma, to which petitioner sold grain purchased from members and nonmembers for sale and storage, and Farmland Industries, Inc. (Farmland), a regional supply cooperative of Kansas City, Missouri, from which petitioner acquired agricultural supplies for sale to its members and nonmembers. As a local cooperative, petitioner received patronage dividends from the regional cooperatives of which it was a member, including Union Equity and Farmland.

Petitioner, Union Equity, and Farmland utilized the basic cooperative principle of patronage refunds—i.e., the annual net income of the cooperative from business done with or for its member-patrons was allocated to member-patrons on the basis of the relative amount of patronage during the year. This income was then distributed as patronage dividends within 8½ months of the cooperative's yearend.

Petitioner's bylaws required apportionment of petitioner's net earnings at least annually by the directors, subject to revision by the members at an annual or special meeting. Petitioner held annual meetings of its membership, attended by approximately 545, 600, and 470 persons in 1979, 1980, and

1981, respectively. During these meetings, members were apprised of the business of petitioner, nominations and elections of directors were conducted, and, after an opportunity for discussion by petitioner's members, the apportionment of earnings recommended by the directors was ratified.

Petitioner's members were informed on a regular basis of the cooperative's business and the allocation of all components of the patronage dividends, including those received from Union Equity and Farmland. This information was disseminated by petitioner in the annual report, monthly newsletters, yearly patronage statements accompanying dividend payments, and on an informal basis through discussions among the members, directors, and general manager. Petitioner's members thus had notice and presumptively were aware for many years that patronage dividends received from Union Equity and Farmland were included in petitioner's income in the year of receipt and assigned to petitioner's pertinent allocation units. They presumptively were aware that those patronage dividends were a part of the net earnings in each of petitioner's allocation units that were distributed to petitioner's members in proportion to the business those members did with petitioner in each of its allocation units in the year the particular patronage dividend was received.

Petitioner's Business Operations and Transactions With Its Members

Petitioner's members had substantial flexibility in selling their wheat to, or storing it with, petitioner upon harvest. Upon delivery for sale or storage, petitioner commingled the wheat with its wheat inventory then on hand. Members sold their crops to petitioner at various times depending on market conditions and available Government programs.

As required under Federal warehouse licensing requirements, petitioner maintained records on a daily basis showing beginning inventory, wheat purchases and sales, and closing wheat inventory. Petitioner maintained a daily grain position of grain stored with it, either in open storage or in other warehouses for which petitioner received a receipt, and of grain purchased from its members.

Petitioner's grain purchases exceeded its sales. Petitioner's sales to Union Equity occurred at various times during the

year depending on the size of petitioner's owned inventory and market conditions. Because of the fungible nature of wheat, petitioner could not identify particular sales to Union Equity with particular purchases from members. Neither the source of grain shipped by petitioner to Union Equity nor the year such grain was harvested and delivered to petitioner could be identified.

Petitioner also sold member wheat from time to time to corporations that were not organized as cooperatives. During the year in issue, petitioner sold 2,182 bushels of wheat to private entities that were not organized as cooperatives. In April and May 1980, petitioner sold 70,000 bushels of wheat to the Commodity Credit Corp. These sales did not generate any patronage dividends from the purchasers nor from Union Equity. Petitioner could not identify which purchases from its members generated these sales.

Petitioner purchased various items of equipment and supplies used by its patrons in their farming operations. These goods were purchased primarily from Farmland and held in inventory by petitioner for sale to its members. Petitioner frequently made purchases from Farmland in anticipation of member needs, often in the off-season in order to secure a price advantage. Thus, items were held in inventory by petitioner for varying lengths of time depending on its inventory and member demand for a particular item. Many items were held in inventory beyond the close of the fiscal year of the entity from which petitioner purchased the item and/or beyond the close of the fiscal year in which petitioner acquired the item. The sale of a particular item could not be identified with the prior purchase of that item by petitioner. Although petitioner conducted an annual inventory of its merchandise, it could not determine the period for which a particular item had been held in inventory.

Because of the seasonal nature of farming, petitioner's month-to-month profitability varied significantly during its fiscal year. Some periods of time during the year were associated with losses, while others were associated with higher than average profits. Petitioner's sales, cost of sales, inventories, gross margins, and net earnings in each of its allocation units varied substantially from month to month during its 1979, 1980, and 1981 fiscal years. Thus, petitioner's

net earnings available for payment of patronage dividends were not generated evenly over its fiscal year.

Nonmargin items such as shrinkage, interest expenses, salaries, overhead, taxes, and depreciation affected the amount of petitioner's net earnings available for distribution to its members. These items were not identified with any particular transactions in computing petitioner's patronage dividend.

Union Equity's Business Operations and Transactions With Petitioner

At all relevant times, petitioner's transactions with Union Equity related solely to sales and storage of wheat. Union Equity purchased wheat from members in quantities ranging from 600 to 3,300 bushels. Grain purchased from petitioner and others was commingled by Union Equity in its inventory of owned grain from which Union Equity thereafter made its sales. Union Equity maintained a grain inventory that was valued at market (realizable value adjusted for freight) determined from open sale contracts or Houston bid price, adjusted for net gains or losses on open commodity contracts. Union Equity ordinarily sold its grain in vessel quantities ranging from 1 million to 2.5 million bushels. Because of the fungible nature and the commingling of grain, sales could not be identified with particular prior purchases.

Union Equity's sales, cost of sales, inventories, gross margins, and net earnings in each of its allocation units varied substantially from month to month during the years ended December 31, 1979, 1980, and 1981. During calendar year 1979, Union Equity's grain inventory ranged from $18 million on June 1, to $130 million on November 1; monthly sales ranged from $43 million in May to $113 million in December. These variations were due primarily to weather and market conditions. The grain market price often fluctuated significantly between the purchase of a specific quantity of grain and the sale of a similar quantity by Union Equity. Thus individual transactions were not equally profitable.

Union Equity's net earnings available for payment of patronage dividends to petitioner and other local cooperatives were not generated evenly over 1979. Some periods during the

year were associated with losses, while others were associated with higher than average profits.

Nonmargin items such as overhead expenses, interest expenses, hedging income and loss, patronage dividends from other cooperatives, and depreciation affected the amount of Union Equity's net earnings available for distribution to petitioner and other members. These items were not identified with any particular grain transaction nor with particular months.

Union Equity classified each transaction by patron account number and commodity on a daily basis. This information was used by Union Equity at yearend to allocate net earnings in each allocation unit between patrons and nonpatrons, and as the basis upon which the portion of member net earnings in each allocation unit was allocated to business done with or for patrons according to Union Equity's bylaws.

In computing its net earnings for each of its allocation units, Union Equity based its calculations on averages. It did not look to specific transactions, nor was it possible to determine to which grain purchases the net earnings in a particular year or month were attributable. Union Equity determined its total patronage dividend paid on May 31, 1980, by reference to the net earnings reflected in its financial records for the year ended December 31, 1979. Union Equity allocated the total patronage dividends to the patrons of its grain marketing and grain storage allocation units according to the quantity of wheat sold to Union Equity and the amount of storage fees incurred with Union Equity by each patron in the year ended December 31, 1979.

Farmland's Business Operations and Transactions With Petitioner

At all relevant times, Farmland purchased, produced, and processed various farm supplies, added them to bulk inventories and made sales from inventories to its members. Because of the fungible nature of its supplies, sales could not be identified with particular purchases or production. Farmland maintained inventories valued on a lower of cost or market basis for each of its product lines.

Farmland's sales, cost of sales, inventories, gross margins, and net earnings in each of its allocation units varied

substantially from month to month during the years ended August 31, 1979, 1980, and 1981. Due to the seasonal nature of farming, Farmland's supply inventory levels fluctuated. Farmland's sales of a single product in an allocation unit were not all equally profitable due to the impact of market demand, transportation costs, and weather conditions.

Farmland's net earnings available for payment of patronage dividends to petitioner and other local cooperatives were not generated evenly over Farmland's fiscal year ended August 31, 1980. Some periods during the years ended August 31, 1979, 1980, and 1981, were associated with losses, while others were associated with higher-than-average profits. During fiscal year 1980, Farmland's monthly net earnings ranged from approximately $1 million in December to approximately $51.6 million in August.

Nonmargin items such as warehousing, general overhead, and corporate expenses affected the amount of Farmland's net earnings available for distribution to petitioner and other members. These items were not identified with particular transactions between Farmland and its members.

Farmland classified each transaction by patron account number and commodity on a daily basis. This information was used by Farmland at yearend to allocate net earnings in each allocation unit between patrons and nonpatrons, and as the basis upon which the portion of member net earnings in each allocation unit was allocated to business done with or for patrons according to Farmland's bylaws.

Farmland made no attempt to determine whether particular transactions were profitable. Rather, it determined annually whether there were earnings in each of its allocation units. In computing net earnings for each of its allocation units, Farmland did not look to specific transactions, nor was it possible to determine to which sales the net earnings in a particular period were attributable. To the extent a unit had net earnings, they were distributed ratably to the Farmland members who patronized that unit.

Farmland determined its total patronage dividend paid on December 31, 1980, by reference to the net earnings reflected in its financial records for the year ended August 31, 1980. Farmland allocated the total patronage dividends to the patrons of each of its allocation units according to the dollar

amount of products of that unit purchased from Farmland by each patron during the fiscal year.

Computation of Petitioner's Patronage Dividends

For its cooperative accounting purposes since at least fiscal year 1973, petitioner allocated its annual patronage dividend among seven allocation units: wheat; other grain; grain storage; feed, seed, and farm supplies; service income; anhydrous ammonia fertilizer; and other fertilizer. Petitioner followed this allocation method with respect to its patronage dividend for fiscal year 1981.

Petitioner's directors made an annual allocation of petitioner's net earnings from its seven allocation units upon recommendation of its auditors and general manager. Pursuant to petitioner's bylaws, net earnings accrued on business transacted with or for members, in excess of reserve fund and tax requirements, were required to be apportioned among all members on the basis of patronage and distributed in cash, merchandise, credits on capital stock, member equity credits, special reserves, certificates of equity, or any form of non-interest-bearing instrument without due date.

During fiscal year 1981, petitioner received patronage dividends from cooperatives of which it was a member-patron as follows:

	Payor's FYE	*Date paid*	*Amount received*
Union Equity Cooperative, Inc	12/31/79	05/13/80	$68,553.56
Farmland Industries, Inc	08/31/80	12/31/80	131,425.43
Wichita Bank for Cooperatives[4]	12/31/79	03/23/81	18,690.47
Pioneer Telephone Co			0
Total			218,669.46

The patronage dividend distribution received by petitioner from Union Equity in 1980 was allocated and distributed on the basis of business done by petitioner with Union Equity in Union Equity's year ended December 31, 1979. It included petitioner's share of patronage dividend distributions received

[4]The patronage dividend received by petitioner from the Wichita Bank for Cooperatives was accounted for as a reduction in interest expense otherwise reducing net earnings available for distribution.

by Union Equity in 1979 from other cooperatives of which Union Equity was a member. The patronage dividend distribution received by petitioner from Farmland in 1980 was allocated and distributed on the basis of business done by petitioner with Farmland during Farmland's fiscal year ended August 31, 1980. It included petitioner's share of patronage dividend distributions received by Farmland during its 1980 fiscal year from other cooperatives of which Farmland was a member.

In computing the amounts of its net earnings distributable to member-patrons on a patronage basis for its 1981 fiscal year, petitioner included in gross income the patronage distributions received from Union Equity and Farmland in 1980. Of the $68,553.56 patronage dividend received from Union Equity, $64,939.40 was attributable to wheat marketing and $3,614.16 was attributable to storage. Petitioner included $64,939.40 in its 1981 gross income in its wheat marketing allocation unit and $3,614.16 in its 1981 gross income in its storage allocation unit. After determining the percentage of 1981 fiscal year wheat purchases by hundredweight from members and nonmembers, petitioner allocated the portion of its 1981 fiscal year net earnings of its wheat marketing allocation unit relating to member business in proportion to the volume of wheat marketing business transacted with or for each of its members in fiscal year 1981. Petitioner allocated the portion of its 1981 fiscal year net earnings of its storage allocation unit relating to member business in proportion to the dollar value of the storage business transacted with or for each of its members in fiscal year 1981.

The $131,425.93 patronage dividend paid by Farmland was allocable to each of the Farmland allocation units of which petitioner was a member as follows:

Fertilizer	$104,412.63
Agricultural chemicals	1,305.68
Feed	19,887.11
Farm and home	951.88
Lube, oil, and grease	487.54
Tires, batteries, and accessories	472.02
Facilities and equipment	837.02
Local facilities	3,072.05
	131,425.93

Farmland allocated the total patronage dividends to its patrons of each of its allocation units according to the dollar amount of products of that unit purchased from Farmland by each patron in Farmland's fiscal year ended August 31, 1980.

In determining its net earnings for fiscal year 1981, petitioner added the Farmland patronage dividend received during this period to its gross income in its ammonia fertilizer, other fertilizer, and feed, seed, and farm allocation units. After determining the portion of fiscal year 1981 sales in each allocation unit attributable to members and nonmembers, petitioner allocated the member portion of its fiscal year 1981 net earnings in each unit to its members in proportion to the dollar amount of sales to members during the fiscal year.

Petitioner had followed these allocation and distribution practices since at least fiscal year 1973.

During a meeting of petitioner's directors on March 17, 1981, a motion was made and carried, subject to approval of the members, for distribution of earnings for the 1981 fiscal year as follows:

> The surplus account be credited with an amount approximating 10% of the net earnings in keeping with the provisions of the by-laws.
>
> The remainder of the net earnings are to be distributed on the basis of patronage to all members and patrons who are eligible for membership, at least 25% in cash, and the remainder in capital stock and stock credits. All patronage amounts of 99¢ or less to be deleted; all patronage amounts from $1.00 through $3.99 to be paid 100% in cash; stockholders with birthdate of 12/31/1903 or before to receive 100% in cash and all others to receive 25% in cash and the remainder in stock and stock credits.

On April 22, 1981, the directors determined that 25 percent of the patronage dividend would be paid in cash, subject to approval of the members and the Wichita Bank for Cooperatives, and that anyone having attained his 76th birthday would be paid 100 percent in cash.

On May 1, 1981, the directors approved payment of a patronage dividend of $321,079.93 for the 1981 fiscal year according to the following schedule:

	Member volume		*Rate*	*Patronage dividend*
1. Wheat - cwt	772,958.65	@	13.3348 ¢ cwt	$103,072.49
2. Other grain - cwt	7,495.00	@	20.00 ¢ cwt	1,499.00
3. Storage - $	243.349.61	@	28.00 %	68,137.89

	Member volume		*Rate*		*Patronage dividend*
4. Feed, seed and farm supplies - $	710,234.76	@	4.21	%	$29,900.88
5. Service income - $	156,138.26	@	25.00	%	39,034.57
6. NH - 3 $	115,891.45	@	7.00	%	8,112.40
7. Other fertilizer - $	950,969.28	@	7.50	%	71,322.70
					321,079.93

Delete all checks for 99¢ or less

Cash patronage	*Percent of cash*
All checks from $1 through $3.99	100%
Stockholders with stock owned 3/31/81	
$10 through $99.99	25%
$100 or more	25%
Stockholders with birthdate of 12/31/1903 or before	100%

At petitioner's annual stockholders' meeting on May 16, 1981, the financial report was presented by the general manager and, after an opportunity for discussion by petitioner's members, the apportionment of earnings recommended by the directors was ratified.

Petitioner distributed its 1981 fiscal year member net earnings of $321,079.93 in cash and written notices of allocation to its patrons on and immediately after May 17, 1981. Petitioner allocated and distributed its 1981 patronage dividend in its wheat, other grain, and storage allocation units on the basis of quantity of business done with or for its patrons during the 1981 fiscal year. The patronage dividend was distributed within petitioner's anhydrous ammonia, other fertilizer, feed, seed, and farm supplies and service income allocation units on the basis of the value of business done with or for its patrons during the 1981 fiscal year. Petitioner provided its members with a patronage statement detailing the sources of their individual patronage dividend and a letter setting forth the basis upon which the patronage dividend was calculated. Petitioner claimed a patronage dividend deduction of $321,079.93 on its corporate income tax return for fiscal year 1981.

In his notice of deficiency, respondent disallowed $133,864.30 of petitioner's patronage dividend deduction by disallowing all of the amount attributable to the patronage dividend petitioner received from Union Equity and seven-

twelfths of the amount attributable to that received from Farmland. The disallowance was explained as follows:

> It is determined that you incorrectly computed your patronage dividend deduction for the year by allocating to current year patrons the Regional Patronage Dividends received during the year. These Regional Patronage Dividends were earned on business done by prior year patrons.

OPINION

Generally, subchapter T permits cooperatives to deduct from gross income amounts paid to patrons as patronage dividends, and subjects the patrons to tax on these dividends to the extent they arise out of the patrons' business transactions with the cooperative. Secs. 1381 through 1388. Thus the foundation of subchapter T is a single level of tax. See *Riverfront Groves, Inc. v. Commissioner*, 60 T.C. 435, 440–441 (1973).

Although section 1382(a) requires a cooperative to treat patronage dividends as an item of gross income, a corresponding deduction from gross income is allowed under section 1382(b) to the extent that the patronage dividends are properly distributed within the terms of the statute.

The statutory standard for determining the deductibility of patronage dividends is set forth in section 1388(a). This section embodies the equitable allocation principle surrounding this controversy and defines "patronage dividend" as an amount paid to a patron:

> (1) on the basis of quantity or value of business done with or for such patron,
>
> (2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and
>
> (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Section 1388(a) further provides that patronage dividends do not include any amount paid to a patron to the extent that the amount is out of earnings other than from business done with or for patrons, or is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.

The concept of equitable allocation—that earnings must be allocated ratably to the particular patrons whose patronage

created the earnings from which the allocated dividend was made—was a judicially recognized requirement for the deductibility of patronage dividends prior to the enactment of subchapter T. *Lamesa Cooperative Gin v. Commissioner*, 78 T.C. 894, 900 (1982); *Union Equity Cooperative Exchange v. Commissioner*, 58 T.C. 397, 403 (1972), affd. 481 F.2d 812 (10th Cir. 1973). Respondent contends that petitioner's method of allocating regional patronage dividends according to its patronage in the year of receipt violates this principle. Respondent argues that these patronage dividends were properly allocable to those patrons who contributed to the earning of the dividends. Asserting that the regional dividends were earned on business done by prior years' patrons, respondent reduced the patronage dividend deduction claimed by petitioner for the year in issue by advancing a simplistic formula which he claims will result in an equitable allocation: prorate the earnings to the months earned and allocate those prorated earnings ratably to the members of the allocation unit to which the prorated earnings are assigned. Under this formula, respondent determined that the entire patronage dividend received by petitioner from Union Equity and seven-twelfths of that received from Farmland were attributable to business done prior to April 1, 1980, and, therefore, were not properly allocable to petitioner's patrons in the year the dividends were received.

Petitioner contends that in view of the stability of its membership and the fact that the transactions between petitioner, its members, Union Equity, and Farmland span various accounting periods, the allocation method chosen by its democratically elected board of directors, ratified annually and employed consistently for many years, was equitable and reasonable. We agree with petitioner.

Section 1382(f) prescribes the treatment of earnings received after patronage occurred:

> If any portion of the earnings from business done with or for patrons is includible in the organization's gross income for a taxable year after the taxable year during which the patronage occurred, then for purposes of applying * * * [section 1382(b)] the patronage shall, to the extent provided in regulations prescribed by the Secretary, be considered to have occurred

during the taxable year of the organization during which such earnings are includible in gross income.[5]

Despite the express language of section 1382(f) and the absence of a statutory requirement that patronage dividends in some specific circumstances must be allocated to prior years' patrons,[6] respondent maintains that the requirement of equitable allocation necessitates tracing to those patrons whose business generated the earning of the regional dividends.

In support of his theory, respondent relies on a variation of the same type of theoretical arguments he advanced in other cases involving vertical allocations, focusing on the characterization of a cooperative as a conduit or agent. See *Lamesa Cooperative Gin v. Commissioner*, 78 T.C. 894 (1982); *Ford-Iroquois FS, Inc. v. Commissioner*, 74 T.C. 1213 (1980); *Associated Milk Producers, Inc. v. Commissioner*, 68 T.C. 729 (1977). Vertical allocation involves allocation among continuing patrons from year to year, whereas, horizontal allocation involves allocation between patrons and nonpatrons in the same year. See *Lamesa Cooperative Gin v. Commissioner, supra.*

In *Lamesa Cooperative Gin v. Commissioner, supra*, we considered respondent's equitable allocation argument in his attempt to allocate gain on the sale of equipment that had been leased over a 10-year period to members of an exempt cotton gin cooperative to its member-patrons in the years in which the recaptured depreciation was claimed. We concluded that the cooperative's allocation of the gain to its current year patrons was not inequitable under the circumstances. Rejecting respondent's equitable allocation argument, we stated:

the requirement of "equitable allocation" should not be seen as a strict accounting requirement but as only a general principle to prevent inequitable treatment to some patrons at the expense of others. As a principle of equity, the overall scheme of allocation should be examined, including the practicalities of making allocations, the democratic nature of cooperatives, and the extent of patronage to the cooperative by nonmembers who have no

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[5] Sec. 1.1382-6, Income Tax Regs., provides that patronage will be deemed to have occurred in the year in which the income is includable in the cooperative's gross income.

[6] Cf. sec. 1.1382-3(c)(3), Income Tax Regs., which requires *nonpatronage-sourced* income realized by an *exempt* cooperative from the sale or exchange of capital assets held more than one taxable year to be paid "insofar as is practicable" to the persons who were patrons during the taxable years in which the assets were owned in proportion to the amount of business done by such patrons during such taxable years.

say over how patronage dividends are distributed. [*Lamesa Cooperative Gin v. Commissioner*, 78 T.C. at 903.]

We concluded that the concept of equitable allocation does not require that net margins be allocated precisely in proportion to the patronage that generated them, nor mandate a particular form of accounting. *Lamesa Cooperative Gin v. Commissioner*, 78 T.C. at 902, 907.

Respondent's objections to petitioner's allocation method in this case are not unlike those we rejected in cases involving his past attempts to require tracing with respect to cooperatives' net operating loss deductions through the principle of "operation at cost." The concept of operation at cost means that a cooperative was organized for the purpose of rendering economic services, without gain to itself, to shareholders or to members who own and control it. *Ford-Iroquois FS, Inc. v. Commissioner*, 74 T.C. 1213, 1219 (1980); *United Grocers, Ltd. v. United States*, 186 F. Supp. 724, 733 (N.D. Cal. 1960), affd. 308 F.2d 634 (9th Cir. 1962). We initially rejected respondent's operation-at-cost argument in *Associated Milk Producers, Inc. v. Commissioner, supra*, where he argued that because of this principle, a cooperative by its very nature could not have a net operating loss for tax purposes. Respondent reasoned that in any year in which expenses exceed gross income, the loss must be recovered from the members who were patrons for that period—"i.e., the exact converse of a patronage dividend allocation when income exceeds expenses." We disagreed with respondent's reasoning and concluded that his position constituted "an unwarranted tinkering with the tax structure applicable to cooperatives." *Associated Milk Producers, Inc. v. Commissioner*, 68 T.C. at 735–736.

We subsequently rejected respondent's further refined position in *Ford-Iroquois FS, Inc. v. Commissioner, supra*, where he sought to deny the net operating loss carryforward only for terminated members, and not for all members as he had proposed in *Associated Milk Producers*. In *Ford-Iroquois FS, Inc.*, we examined the cooperative's bylaws and articles, its overlapping membership in its marketing and supply operations, the contacts between the managers and directors of the cooperative and its members, the actual allocations, and the apparent approval of the cooperative's allocation method by its members. We concluded that the cooperative's method of

allocation was practicable, nondiscriminatory, and equitable, and stated that "The allocation of losses among a cooperative's past, continuing, and future members is properly the concern of the membership and its board of directors." *Ford-Iroquois FS, Inc. v. Commissioner*, 74 T.C. at 1220–1222.

Focusing our inquiry on whether the allocation was inequitable in view of the board of directors' considerable discretion, we note that the board's weighing of the equities should be overturned by this Court only when the exercise of that discretion appears to have been unreasonable. *Lamesa Cooperative Gin v. Commissioner*, 78 T.C. at 906.

Respondent recognizes that the Government should not ordinarily interfere with a cooperative's method of allocating earnings, but insists that there are limits beyond which a cooperative may not go without sacrificing operation on a cooperative basis. He acknowledges also that there may be various acceptable methods of allocation. See *Lamesa Cooperative Gin v. Commissioner*, 78 T.C. at 910. Respondent insists, however, that petitioner's allocation method is "ipso facto discrimination" and does not comport with the provisions of subchapter T.

As we noted in *Lamesa Cooperative Gin v. Commissioner*, 78 T.C. at 903, the cases that have found inequitable allocations have generally involved allocations between member and nonmember patrons. E.g., *Petaluma Co-operative Creamery v. Commissioner*, 52 T.C. 457 (1969); *Farmers Union Cooperative Co. v. Commissioner*, 90 F.2d 488 (8th Cir. 1937), affg. 33 B.T.A. 225 (1935). Focusing on the democratic nature of a cooperative, we emphasized that the greatest risk of inequitable allocation arises when a cooperative allocates net margins to members at the expense of nonmembers who have no voice in the election of management. *Lamesa Cooperative Gin v. Commissioner*, 78 T.C. at 903–904. In the case of a vertical allocation problem, however, the management has been directly elected by the members of the cooperative and "the key factor is that the identity of the patrons has remained stable enough so that there is no reason to assume that * * * [Lamesa's] management would be prone to take actions discriminatory against past patrons." 78 T.C. at 905.

Here, as in *Lamesa Cooperative Gin v. Commissioner*, *supra*, the controversy centers around petitioner's allocation of earn-

ings among continuing patrons from year to year, and thus, the key factor is the stability of petitioner's membership. The parties stipulated that petitioner's membership turnover was less than 5 percent during its 1979, 1980, and 1981 fiscal years. Moreover, most of the terminations in membership involved the death or retirement of a member whose membership was subsequently continued by another family member. Thus, it appears that substantially all of petitioner's patrons remained the same from year to year.

Respondent failed even to consider petitioner's overlapping membership. In view of the continuity in petitioner's membership, it is apparent that respondent's proposed adjustment incorrectly disallows amounts that would have been paid to the same patrons under either petitioner's or respondent's allocation method.

Respondent presented no evidence of objections to petitioner's allocation method, nor of any particular instances of discrimination. Petitioner's net earnings were apportioned annually by its directors as required under its bylaws. The directors employed various means of communication to apprise the members of petitioner's business and the allocation of patronage dividends, including newsletters, annual reports, and informal and formal meetings. Although the members were given the opportunity to discuss and object to the directors' allocation of earnings, the evidence establishes that the directors' recommendations were consistently ratified since at least 1979. Because of the stability in petitioner's membership and the total lack of evidence of discrimination against past patrons, we have no reason to suspect any discriminatory action on the part of petitioner's management with respect to its allocation of patronage dividends. To the contrary, it appears that petitioner's directors made a concerted effort to insure that all members were treated fairly.

Another factor to be considered is the practicality of making a particular type of allocation. *Lamesa Cooperative Gin v. Commissioner*, 78 T.C. at 906. Much of the evidence and testimony presented by petitioner relates to the seasonal nature of farming and its effect on transactions among petitioner, its members, Union Equity, and Farmland, including the computation and distribution of patronage dividends. Factors such as the effect of commingled and carryover

inventories, the timing of purchases and sales, unequal profitability among transactions, and sources of net earnings are extremely relevant to our inquiry as to whether petitioner's allocation method was equitable. In our view, these factors are indicative of the practical and conceptual problems underlying the period-tracing method advocated by respondent and the need for the seasoned judgment of petitioner's members and their elected board of directors in adopting an equitable allocation method. It is obvious that the net earnings from a particular period in a regional cooperative's business cycle do not necessarily relate to the local transactions during the identical time period.

The evidence also establishes that the transactions among petitioner, its members, Union Equity, and Farmland overlap the various accounting periods of each entity. The regional cooperatives in turn receive patronage dividends from upper-tier cooperatives of which they are members, each potentially with a different fiscal year. Respondent's method ignores the fact that a patron's transactions necessarily overlap annual accounting periods. The complex calculations that would be required to trace the earnings through the various levels and fiscal years in order to determine which patrons generated the earnings would necessitate tracing of individual transactions despite respondent's claim to the contrary. Such tracing would be costly and cumbersome and is not required by subchapter T, prior precedent, or principles of cooperative accounting.

Petitioner's witnesses, experienced in the cooperative farming business, testified that petitioner's allocation method was in accordance with generally accepted cooperative principles. Petitioner followed this method consistently, apparently without objection, for many years. Respondent has ignored the realities of the cooperative way of business and substituted a method of period-tracing that revolves around the fiscal year of the regional cooperative from which the patronage dividend was received. Respondent presented no evidence, however, to indicate that the regional dividends were in fact attributable to petitioner's patronage during such earlier periods, nor to demonstrate that his method would result in a more accurate and equitable allocation of regional dividends to the local transactions which generated such earnings than that of petitioner.

Considering the stability of petitioner's membership, the practicalities of the allocation, and the apparent approval of petitioner's allocation method by its members, we find petitioner's method to be fair and equitable and within the statutory framework of subchapter T.

Decision will be entered for the petitioner.

MARY JEAN MARTIN, INDIVIDUALLY, AND DOROTHY FISCHER, BY HER GUARDIAN, MARY JEAN MARTIN, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

JOHN R. FISCHER, RICHARD J. FISCHER, WILBURN H. FISCHER, FRANCIS J. FISCHER, AND PATRICIA ANN NORMAN, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 10122–82, 10740–82. Filed April 2, 1985.

P's are the seven heirs of the Estate of John A. Fischer. At his death on Jan. 29, 1978, decedent devised to such heirs, as tenants in common, a 209-acre crop-producing family farm. The farm was leased on a sharecrop basis to the son-in-law of decedent at the time of his death. The estate properly elected, qualified for, and received a special-use valuation pursuant to sec. 2032A, I.R.C. 1954. At the instigation of the personal representative, who was an heir, and over the opposition of two of the heirs, a 1-year cash lease of the entire tillable portion of the farm was executed in August of 1979, and the lease was approved by the local probate court. *Held*, the cash lease of the farm constituted a cessation of qualified use of the farm by a "qualified heir," calling for the imposition of an additional or recapture estate tax pursuant to sec. 2032A(c)(1)(B).

Jack N. Van Stone, for the petitioners in docket No. 10122–82.

Edward W. Johnson, for the petitioners in docket No. 10740–82.

Frederick W. Krieg, for the respondent.

KORNER, *Judge*: Respondent determined deficiencies in estate tax against each of the foregoing seven petitioners in the amount of $95,088.14.[1] Respondent has conceded $81,504.12 of each such deficiency, leaving deficiency determinations in the amount of $13,584.02 in issue as to each petitioner.[2]

After concessions, the sole issue remaining for our decision is whether the seven heirs of the decedent, John A. Fischer, ceased to use qualified real property for a qualified use, so that they are liable for an additional estate tax pursuant to section 2032A(c).[3]

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulations of facts and exhibits attached thereto are incorporated herein by this reference.

At the time their petitions were filed, petitioners John R. Fischer (John R.), Richard J. Fischer (Richard), Francis J. Fischer (Francis), and Patricia Ann Norman (Patricia) resided at Mount Vernon, Indiana; petitioner Wilburn H. Fischer (Wilburn) resided at Corpus Christi, Texas; and petitioners Mary Jean Martin (Mary) and Dorothy Fischer (Dorothy), by her guardian, Mary Jean Martin, resided at Poseyville, Indiana.

John A. Fischer (the decedent) and his wife, Florence Fischer (Florence) were citizens of the United States and resided in Posey County, Indiana, for virtually all of their lives. The decedent and Florence owned, as tenants by the entirety, certain real estate in Posey County, Indiana, consisting of a total of 209 acres, and comprised of approximately 166 acres of farm land, 23 to 26 acres of unproductive and unmanaged woodland of little value, 17 to 20 acres of woods and creeks, and a residence (hereinafter referred to, collective-

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[1] Respondent also determined additions to tax under sec. 6651(a)(1), as to each of the petitioners herein, but has conceded this issue.

[2] Such concessions were explained by respondent as follows:

"In each statutory notice of deficiency issued to the seven petitioners herein, respondent determined the full amount of the additional estate tax, or $95,088.14. Respondent should have determined one-seventh of the full amount of the additional estate tax against each of the seven petitioners, or $13,584.02."

[3] All statutory references are to the Internal Revenue Code of 1954 as amended and in effect for the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise stated.

ly, as the farm). At all times here pertinent, the farm produced various types of crops.

Decedent and Florence Fischer had seven children, namely: John R., Richard, Wilburn, Francis, Dorothy, Patricia, and Mary.

The principal occupation of decedent and Florence Fischer was farming, and they personally farmed the foregoing acreage until approximately 1970, when they were unable to do so as a result of advancing age and poor health. At such time, they entered into an oral sharecrop arrangement with Mary's husband, Anthony Martin (Anthony), whereby he would farm approximately 95 acres of the farm on a sharecrop basis, with one-third of the net proceeds therefrom going to the lessors and the remainder going to Anthony. In 1974, the lease was modified to include the entire farm.

At an undisclosed time prior to 1978, Patricia became the guardian of decedent and Florence Fischer. During 1977, a typewritten lease of the farm was entered into between Patricia, in her guardian capacity, and Anthony, continuing the one-third, two-thirds split between the landlords and the tenant.

On or about March 29, 1977, Florence died, and the farm passed to her husband by operation of law. On January 29, 1978, decedent died.

By the will of the decedent, which was probated, his seven children received the farm as tenants in common. John R. qualified as the personal representative of the estate of his father, and an estate administration was opened in the Posey Circuit Court in Indiana.

From January 29, 1978 until August 1979, the farm continued to be farmed on a sharecrop basis by the decedent's son-in-law, Anthony Martin, pursuant to automatic extensions of the 1977 lease.

On September 29, 1978, John R. caused to be filed with the Internal Revenue Service, a United States Estate Tax Return, Form 706, on which the estate properly elected to value the farm pursuant to section 2032A. The return was accepted as filed and a closing letter was issued by respondent on June 16, 1980. The seven qualified heirs each executed a document styled "Agreement to Remain Liable For Additional Estate

Tax For the Estate of John A. Fischer, Deceased." John R. was appointed the active agent for the qualified heirs.

As filed, the estate tax return showed a total estate tax of $11,473.02. Had the parties not elected the special-use valuation for the farm, the estate would have owed an additional $95,088.14 in estate taxes at the time the return was filed. However, the requirements of section 2032A were complied with, and the estate was entitled to, and properly received, a special valuation for the farm under section 2032A.

By 1978, Dorothy had become mentally incompetent, and on April 13, 1978, Mary was appointed as her guardian, and continued in that capacity at all times here pertinent.

Subsequent to filing the estate tax return, John R. determined that Anthony should not continue farming the property. Accordingly, on February 15, 1979, John R. caused to be sent to Anthony a notice to terminate the typewritten 1977 lease agreement. The notice of termination was to be effective on August 15, 1979, and provided that Anthony was not to thereafter plant any crops to be harvested after that date, and was to have all of his crops off of the farm prior to that date, but Anthony was permitted to remove any crops, already planted, which would not mature until after August 15, 1979.

In July or early August of 1979, John R. advertised for bids to lease the farm for a 1-year period on a pure cash rental basis. Several sealed bids were submitted, each of which was based on a fixed dollar amount. When the sealed bids were opened in August 1979, the highest bid was submitted by Droege Farms, which submitted a cash rental bid of $21,060. On August 17, 1979, a cash lease of the farm was entered into by and between the personal representative and Edmund Droege, acting for Droege Farms as lessee. Edmund Droege was a third party, who was not related to the decedent or Florence. The contract provided for payment of 10 percent of the total rent on or before September 1 of the year in which the lease was signed, with the remainder due on or before the last day of January 1981.

On August 24, 1979, John R., as personal representative, petitioned the Posey Circuit Court to approve the lease to Droege Farms. At least in part as a result of concern over losing the advantages of the special use valuation under section 2032A, two of the heirs, Mary in her individual

capacity, and Mary as guardian of Dorothy, filed written objections to the lease. Over such objections, on October 16, 1979, the Posey Circuit Court approved the lease.

The rental specified in the cash lease, $21,060, was based upon $117 per acre multiplied by 180 tillable acres. The initial 10-percent payment specified in the lease, or $2,106, was paid in the Spring of 1980, after which time it was determined that there were only 165.9 tillable acres. Accordingly, the final lease payment was adjusted to $17,304.30, computed as the product of 165.9 acres and $117, less the $2,106 initial payment. The rental was not based upon the level of crop production from the farm.

On September 12, 1979, Mary, acting individually and as guardian for Dorothy, filed with the Posey Circuit Court a petition for partition of the farm.

In or about October of 1979, Anthony, the prior lessee, was permitted to and did enter the farm to remove his crops. Between August 17, 1979, and October of 1979, while Anthony's crops were still in the field, and prior to approval of the cash lease by the Posey Circuit Court, Droege Farms did not plant. In November of 1979, however, Droege Farms planted winter wheat, and it likewise was permitted to and did remove its crops in or about October of 1980. Droege Farms thereafter sold the crop, and made the final rental payment under the August 17, 1979, cash lease on December 29, 1980. On August 17, 1980, the 1-year cash lease to Droege Farms ended.

During the cash lease of the farm, the farming operation was conducted by Droege Farms, which used its own chisel plow, moldboard plow, grader blade, disc, culti-mulchers, planters, drill, tractor, and combine. The estate owned no farm equipment.

During the cash lease term, Richard and John R. participated in maintenance and operation of the farm by performing a number of duties, including clearing approximately one-half mile of fence rows, repairing field tile and a washed-out culvert, and filling so-called sinkholes on the farm. In addition, John R. regularly conferred with Edmund Droege, providing advice to the lessee concerning the location for planting crops, plowing and fertilizing methods, crop rotation, seed selection,

disking, control of Johnson grass and other weeds, and rototilling.

At the termination of the 1-year cash lease, a sharecrop lease was executed on August 19, 1980, by and between John R., acting as agent for himself, Richard, Wilburn, Francis, and Patricia, and Edmund Droege, acting for Droege Farms, for the lease of a portion of the farm consisting of approximately 143 acres. Droege Farms has continued to operate this portion of the farm on this basis. At or about the same time, Mary and her husband, Anthony, began farming the remaining portion of the farm, or some 65 acres, which constituted a two-sevenths share of the entire farm.

On October 16, 1980, some 4 months after issuance of his closing letter, respondent first became aware of the August 19, 1979, cash lease between the personal representative and Droege Farms.

The estate of the decedent was closed on or about November 3, 1980, and the entire farm was thereafter transferred to all seven heirs as tenants in common.

On May 11, 1982, the Posey Circuit Court approved an agreement of the parties to partition the farm. Pursuant to the agreement, 142.5 acres were set off as the sole property of John R., Richard, Wilburn, Francis, and Patricia as tenants in common, and 65.3 acres were set off as the sole property of Mary, individually, and Dorothy, by Mary as guardian.

OPINION

The sole issue presented for our decision is whether the seven heirs of the decedent, all of whom are petitioners herein, ceased, by virtue of cash leasing the farm to Droege Farms, to use qualified property for a qualified use, calling for imposition of the additional estate tax (also called a recapture tax) under section 2032A(c). Since the applicability of the recapture tax is an issue of first impression with this Court, we begin with a brief review of the history and purposes of section 2032A.

Section 2032A was added by the Tax Reform Act of 1976, Pub. L. 94–455, 90 Stat. 1520. Under prior law, the value of property included in the decedent's gross estate was the fair market value of the property interest at the date of death (or the alternate valuation date). Secs. 2031, 2032. Such fair

market value was determined with regard to the "highest and best use" to which the property could be put. Later, however, Congress came to feel that this "highest and best use" valuation was inappropriate in the case of land actually used for farming or certain other purposes both before and after the decedent's death, for the following reasons:

> Valuation on the basis of highest and best use rather than actual use may result in the imposition of substantially higher estate taxes. In some cases, the greater estate tax burden makes continuation of farming etc., activities not feasible because the income from these activities is insufficient to service extended tax payments on loans obtained to pay the tax. Thus, the heirs may be forced to sell the land for development purposes. [S. Rept. 94–938 (1976), 1976–3 C.B. (Vol. 3) 643, 657.]

At the same time, it was realized that it would be a windfall to the beneficiaries to provide the foregoing relief in instances where the beneficiaries did not continue to use the property for a reasonable period as the decedent did before death.

In response to these concerns, Congress enacted section 2032A in 1976, providing for an elective procedure whereby the executor could value certain qualified real property included in the gross estate on the basis of the value of the property in its current use, rather than its highest and best use. It was intended that this benefit would apply to family farms or businesses. See *Estate of Sherrod v. Commissioner*, 82 T.C. 523, 531 (1984), on appeal (11th Cir., Oct. 19, 1984); H. Rept. 94–1380 (1976), 1976–3 C.B. (Vol. 3) 735, 755–756.

To qualify for the special use valuation, the following conditions must be met: (1) The decedent at the time of his death must have been a citizen or resident of the United States; (2) the property for which the special use value is sought must be located within the United States; (3) the property must pass to a member of the decedent's family who qualifies under section 2032A; (4) the property must represent at least 50 percent of the adjusted value of the gross estate and must have been used at the decedent's death for a qualified use; and (5) 25 percent or more of the adjusted value of the gross estate must consist of such property which during 5 of the 8 years preceding the decedent's death was used for a qualified use by the decedent or a member of his family, and there must have been material participation by the decedent or the member of his family in the operation of the farm or

other business. See *Estate of Sherrod v. Commissioner, supra* at 532.

The parties herein are in agreement that the estate of the decedent qualified for and properly elected the special use valuation under section 2032A. The instant dispute arises, however, with respect to the post-death use of the farm during administration of the estate, as a result of which, respondent urges, the qualification of the estate for the special-use valuation ceased.

In accordance with the foregoing congressional intent to avoid windfall benefits for beneficiaries who ceased to continue using property as the decedent did for a reasonable post-death period, section 2032A(c)(1) provides for imposition of an additional estate tax, as follows:

> (1) IMPOSITION OF ADDITIONAL ESTATE TAX.—If, within 15 years[4] after the decedent's death and before the death of the qualified heir—
>
> (A) the qualified heir disposes of any interest in qualified real property (other than by a disposition to a member of his family), *or*
>
> (B) *the qualified heir ceases to use for the qualified use the qualified real property which was acquired (or passed) from the decedent, then there is hereby imposed an additional estate tax.*
>
> [Emphasis added.]

Pursuant to section 2032A(b)(2), the "qualified use" referred to in the foregoing section 2032A(c)(1)(B) is defined by reference to the same definition which applies to the pre-death qualified use requirement for initial qualification, as follows:

> (2) QUALIFIED USE.—For purposes of this section, the term "qualified use" means the devotion of the property to any of the following:
>
> (A) use as a farm for farming purposes, or
>
> (B) use in a trade or business other than the trade or business of farming.

The legislative history of section 2032A makes it clear that for either of the foregoing uses to qualify, it must constitute a trade or business, and not a merely passive rental use. As noted by the House Ways and Means Committee in its report explaining the foregoing provision:

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[4] For the estates of decedents dying after Dec. 31, 1981, this period was amended to the present 10 years. Pub. L. 97-34, sec. 421(c)(1)(A), 95 Stat. 172, 307.

In the case of either of these qualifying uses [use as a farm for farming purposes or use in a trade or business other than farming], your committee intends that *there must be a trade or business use. The mere passive rental of property will not qualify.* However, where a related party leases the property and conducts farming or other business activities on the property, the real property may qualify for special use valuation. * * * However, if the property is used in a trade or business in which neither the decedent nor a member of his family materially participates, the property would not qualify. [H. Rept. 94–1380 (1976), 1976–3 C.B. (Vol. 3) 735, 757; emphasis added.]

As noted *supra*, additional estate tax is imposed under section 2032A(c)(1)(B), where there is a cessation of the aforedescribed "qualified use" of qualified property by the qualified heir. The phrase "cessation of qualified use" is defined in section 2032A(c)(7),[5] as follows:

(7) CESSATION OF QUALIFIED USE.—For purposes of paragraph 1(B), real property shall cease to be used for the qualified use if—

(A) *such property ceases to be used for the qualified use set forth in subparagraph (A) or (B) of subsection (b)(2) under which the property qualified under subsection (b); or*

(B) during any period of 8 years ending after the date of the decedent's death and before the date of the death of the qualified heir, there had been periods aggregating 3 years or more during which—

(i) in the case of periods during which the property was held by the decedent, there was no material participation by the decedent or any member of his family in the operation of the farm or other business, and

(ii) in the case of periods during which the property was held by any qualified heir, there was no material participation by such qualified heir or any member of his family in the operation of the farm or other business.

[Emphasis added.]

Imposition of the additional estate tax after the decedent's death can therefore be triggered by any one, inter alia, of the following events:

(a) A failure to continue the *same qualified use* of the property, which was the basis of its original qualification, section 2032A(c)(7)(A);

(b) A failure by a *qualified heir* to continue such use, section 2032A(c)(1)(B); or

(c) A failure of *material participation* by a qualified heir in continuing the same qualified use, section 2032A(c)(7)(B).

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[5] A similar provision is now contained in sec. 2032A(c)(6).

In the instant case, respondent has not raised a material participation objection under section 2032A(c)(7)(B). Rather, respondent contends that the farm ceased to be used by the qualified heirs for the farm use for which it initially qualified, because of the 1-year cash lease entered into with Droege Farms.

As we have found, the farm qualified under section 2032A at the time of the decedent's death, when it was being farmed on a sharecrop basis by the decedent's son-in-law. After the death of the decedent, however, John R., acting as personal representative of his father's estate, notified Anthony to terminate his sharecrop leasing of the farm effective on August 15, 1979. During the summer of 1979, John R. solicited bids to lease the farm for a 1-year period on a pure cash rental rather than a sharecrop basis. The lease went to the highest bidder, Edmund Droege, acting for Droege Farms, and an all-cash lease was executed on August 17, 1979, and then approved by the Posey Circuit Court, over the opposition of two of the heirs of the decedent, on October 16, 1979. The lease called for a flat rental of $21,060 for the year, computed as the product of a $117 rental per acre, and the 180 tillable acres on the farm, and such rental was to be due and payable without regard to any production from the farm.

In an opinion of this Court which was filed after the trial in the instant case, *Estate of Abell v. Commissioner*, 83 T.C. 696 (1984), we held that the decedent's lease of a cattle ranch to an unrelated party for a pure cash rental, for many years ending with her death, failed to constitute a qualified use by the decedent under section 2032A, since under the lease, the decedent had no "equity interest" in the trade or business being operated on her property by the lessee. As was the case with several of the heirs herein, the decedent in *Abell* continued to participate in the management, supervision, and operation of the ranch, but such activities failed to overcome her relinquishment of an equity interest in the cattle business (i.e., a qualified use) during the term of and as a result of her cash lease of the property.

Since, as noted *supra*, a cessation of qualification for the special treatment of section 2032A will occur when property ceases to be used by the qualified heir for the use with respect to which it first qualified, we believe that our holding in *Estate*

of Abell, which related to the initial qualification of property based upon its pre-death use by the decedent, controls the instant case, which relates to continued qualification based upon post-death use by the heirs. In accordance with *Estate of Abell*, the rental of the farm to Droege Farms for a pure cash rental during portions of 1979 and 1980, clearly constituted a cessation of the same qualified use by the qualified heirs, calling for imposition of the recapture tax under section 2032A(c)(1)(B).[6]

In support of their contention that no such cessation occurred, petitioners rely upon two cases, both of which address the qualified use requirement of section 2032A in the context of the pre-death use test for the initial special use qualification of farm or business property under subsection (b)(1).

In the first such case, *Estate of Sherrod v. Commissioner*, *supra*, this Court held qualified for special use valuation under section 2032A, a total of 1,478 acres of land, of which, at the time of the decedent's death, 1,108 acres were in timber, and the remaining 370 acres were in row crops or pasture, and were cash-leased to third parties. Essential to our decision in that case were the facts that the cash-leased acreage constituted only 25 percent of the total acreage, and that the management of the leased acreage had for many years been "an integral part of, and inseparable from," the management of the timber acreage. Furthermore, we found that the practice of leasing the 370 acres was "consistent with good land management," since the land consisted of two parcels, each of which was too small to profitably use for row crops and which were too distant to work as a unit, and provided cash with which to pay such expenses as taxes for the entire property. On these facts, we concluded that the management of the 370 leased acres constituted part of the "active farm business" in which the decedent (or his son) was involved on the remaining 1,108 acres.

In the instant case, by contrast, it was initially determined that Droege Farms would lease 180 tillable acres, or some 86

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[6] We need not decide whether the qualified heirs, through John R. as personal representative, were engaged in a trade or business, and therefore in a "qualified use" under sec. 2032A(b)(2)(B), when they leased the farm to Droege Farms. Even if they were, it was not the trade or business of farming, which was the basis of the initial qualification. Sec. 2032A(c)(7).

percent of the total acreage. While the estimate of tillable acreage was later reduced to 165.9 acres (with a commensurate reduction in the rent), this still constituted some 79 percent of the total acreage. Furthermore, unlike *Estate of Sherrod*, there is no evidence to show that any active farming business was conducted on the remaining acreage, which by stipulated agreement of the parties, consisted essentially of 23 to 26 acres of "unproductive and unmanaged woodland of little value" and 17 to 20 acres of woods and creeks and a residence.

In sum, *Estate of Sherrod* holds that property may be put to a qualified use under section 2032A, notwithstanding that a portion of such property is leased for a flat cash sum, but only where the leased portion is a relatively small part of the entire property and where the requisite nexus can be shown between the leased portion and the conduct of the active business of farming on the remainder of the property.[7] During the term of the cash lease to Droege Farms, however, petitioners have failed to demonstrate the presence of either of these essential conditions.[8]

The second case relied upon by petitioners is *Schuneman v. United States*, an unreported case (C.D. Ill. 1984, 84–1 USTC par. 13,561), supplementing 570 F. Supp. 1327 (C.D. Ill. 1983). In that case, the District Court for the Central District of Illinois, on facts similar to those in the instant case, examined the legislative history of section 2032A, holding that the qualified use provision required the decedent (or, under the 1981 amendments, a member of her family) to be "using" the property at the time of her death, and that a mere passive rental for a cash sum would not qualify. 570 F. Supp. at 1330. In rejecting the plaintiff's position that it was the material participation requirement that was intended to involve the

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[7] In support of this interpretation of *Estate of Sherrod v. Commissioner*, 82 T.C. 523 (1984), on appeal (11th Cir., Oct. 19, 1984), see *Estate of Trueman v. United States*, 6 Cl. Ct. 380 (1984), which was decided after filing of the initial briefs herein.

[8] Petitioners make much of our findings in *Estate of Sherrod v. Commissioner*, *supra*, that the decedent and later his son negotiated annual rental agreements, periodically inspected the timberland and contacted tenants and adjoining landowners, and paid local taxes on the acreage there in issue. We cannot agree with petitioners, however, that such activities formed the basis for our conclusion in that case that the use of the property was a *qualified use* under sec. 2032A(b)(2). Rather, the cited findings related to our further conclusion that there was "material participation," within the meaning of sec. 2032A(b)(1)(C), a separate requirement under sec. 2032A (see *Estate of Coon v. Commissioner*, 81 T.C. 602, 606 (1983)), and one as to which there is no dispute in the instant case. See *Estate of Sherrod v. Commissioner*, *supra* at 534–535. See also *Estate of Abell v. Commissioner*, 83 T.C. 696 (1984).

decedent in the active operation of the farm or other business, and not the qualified use requirement, the District Court noted that "While both requirements insure that the decedent (or a member of his family in the case of material participation) is connected with the property, *they are separate requirements.*" 570 F. Supp. at 1330. (Emphasis added.)

After reaching the foregoing conclusions, with which we are in full accord, the District Court proceeded in that case to note that the decedent would be considered as using the property at her death if the lease of the property at that time was substantially based on production, *or* if the decedent materially participated in operation of the farm. 570 F. Supp. at 1332. We concur, of course, that a pre-death use will be found to be qualified under section 2032A(b)(2), where the decedent leased the property for a rental which was substantially dependent upon production, such as a sharecrop lease. However, in suggesting that a qualified use may be found solely by virtue of the decedent's material participation in operation of the farm property, we believe that the District Court contradicted its own correct observation that qualified use and material participation are two separate and distinct requirements under section 2032A(b). See *Estate of Abell v. Commissioner*, *supra*; *Estate of Trueman v. United States*, *supra*.

Petitioners raise a number of arguments in opposition to the conclusion that the August 1979 lease to Droege Farms constituted an event calling for the imposition of additional estate tax under section 2032A(c)(1)(B). Many of petitioners' arguments are directed toward convincing us that section 20.2032A–3, Estate Tax Regs., which was promulgated on July 28, 1980, T.D. 7710, 1980–2 C.B. 254, and which relates to the material participation requirements for special use valuation, is inapplicable to the instant case. Specifically, the portion of the regulation objected to by petitioners provides that "All specially valued property must be used in a trade or business. * * * The mere passive rental of property to a party other than a member of the decedent's family will not qualify." Sec. 20.2032A–3(b)(1), Estate Tax Regs.

We note that in considering the issue of the qualified use of property passed by a decedent who died in 1979, in *Estate of Abell v. Commissioner*, *supra*, this Court cited the foregoing regulation with approval. We believe that a reading of *Estate*

of Abell makes it clear that the decision therein was grounded upon a careful analysis of the language and legislative history of section 2032A, and not upon the regulation. Since our determination of the instant case is similarly premised upon the language and legislative history of section 2032A, and is made without regard to the cited regulation, we need not consider further petitioners' arguments with respect thereto.

Petitioners next make two arguments relating to Indiana State law. First, petitioners contend that they should not be "penalized" under section 2032A for activities allegedly undertaken pursuant to their purported responsibility under Indiana law to use the property in the estate to obtain the highest income therefrom. In support of this position, however, petitioners point solely to two sections of Indiana law, Indiana Code Annotated sections 29–1–16–1 and 29–1–17–7 (Burns 1972), neither of which provides that property in an estate must be used as was done here. Rather, the first section cited relates to the liability of the personal representative for certain losses suffered by the estate as a result of his negligence or nonfeasance in the performance of his responsibilities. Petitioners appear to argue that John R. could have been held liable under this section if he had *not* entered into the lease with Droege Farms, the premise being that only thus could he derive the maximum return for the heirs. Such an assumption is entirely unproved in this record; there is no proof that John R. could not have done just as well by continuing the existing sharecrop arrangement with Anthony or someone else, e.g., Droege Farms.

The other section of Indiana law relates to the responsibility of the personal representative to disburse, distribute, and account for certain income received by him during administration of the estate, and petitioners do not contend that there was any failure on the part of John R. to meet his responsibilities under this provision, nor that there would have been if he had not entered into the lease.

Second, petitioners point to Indiana Code Annotated section 29–1–13–1 (Burns 1972), which provides, inter alia, that the personal representative shall take possession of all of the real and personal property of the decedent, and that he "may maintain an action for the possession of real property or to determine the title to the same." Pursuant to this section,

according to petitioners, "the heirs of this * * * estate could not have ceased to use the farm in question when the heirs, [sic] never had control of the farm in the first place." The heirs, petitioners contend, only began to have use of the farm in late 1980, after the estate was closed.

We cannot concur in petitioners' contention that they did not have use of the farm until late 1980, within the meaning of section 2032A. As we have found, immediately after the death of the decedent (as before), his son-in-law, Anthony, continued to operate the farm under the 1977 lease, as extended. Since, by stipulated agreement of the parties, the estate was "entitled to, and did receive, a special valuation for the entire farm under Section 2032A," [Stip. 14] it is clear that Anthony was a qualified heir (section 2032A(e)(1) and (2)) using qualified property for a qualified use under that section.

The sole provision which might have excused petitioners' failure to use the farm for a post-death qualified use during all or a portion of the period of administration of the decedent's estate, is section 2032A(c)(7)(A), which was added by section 421(c)(2)(A) of the Economic Recovery Tax Act of 1981, Pub. L. 97-34, 95 Stat. 172, and which establishes a 2-year grace period immediately following the date of the decedent's death, as follows:

> (A) NO TAX IF USE BEGINS WITHIN 2 YEARS.—If the date on which the qualified heir begins to use the qualified real property (hereinafter in this subparagraph referred to as the commencement date) is before the date 2 years after the decedent's death—
>
> (i) no tax shall be imposed under paragraph (1) by reason of the failure by the qualified heir to so use such property before the commencement date, and
>
> (ii) the 10-year period[9] under paragraph (1) shall be extended by the period after the decedent's death and before the commencement date.

While this provision is generally retroactive to estates of decedents dying after December 31, 1976, including the estate of the decedent[10] (see Pub. L. 97-34, sec. 421(k)(5), 95 Stat. 172, 314), it does not benefit petitioners in the instant case, since Anthony, who was a qualified heir within the meaning of section 2032A(e)(1) and (2), was involved in the qualified post-

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[9] For the year here in issue, this was a 15-year period.

[10] Petitioners make no claim under such section, apparently because of their mistaken belief that the section is not to be retroactively applied.

death use of the farm (i.e., the sharecrop lease) *immediately* after the death of the decedent. Moreover, even if Anthony's use of the farm did not constitute the beginning of the qualified use of the farm by the qualified heir within the meaning of the new section 2032A(c)(7), two years after the death of the decedent, or in January of 1980, the farm was still under cash lease to Droege Farms, vitiating the precondition for application of the relief provided for in section 2032A(c)(7)(A) (i.e., that the use by a qualified heir begin within 2 years after the decedent's death).

It is petitioners' next contention that the farm was cash leased for such a short period of time, relative to the time that it was farmed on a sharecrop basis, that no real "cessation of qualified use" occurred. As conceded by petitioners, however, neither the Code nor the regulations allow for any de minimis exception to the qualified use requirement of section 2032A, and we see no basis for reading such an exception into that provision.

Finally, petitioners contend that the heirs of the decedent "did materially participate and contribute to the maintenance and operation of the farm during the term of the cash lease." Even assuming that the activities of some or all of the heirs constituted material participation during the period of the cash lease to Droege Farms, however, a cessation of qualified use occurs under section 2032A(c)(7) upon *either* a failure of material participation for a specified duration, *or* a failure of qualified use by the qualified heirs. In this case, such a failure of qualified use by the qualified heirs is clearly shown, is not cured by any "material participation" by petitioners (*Estate of Abell v. Commissioner*, *supra*), and must give rise to the imposition of additional estate tax under section 2032A(c)(1)(B).

To reflect the foregoing,

Decisions will be entered under Rule 155.

JOHN T. WRIGHT AND SUSAN L. WRIGHT, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 35147–83. Filed April 8, 1985.

Held: Petitioner's conviction under sec. 7206(1), I.R.C. 1954, does not collaterally estop petitioners from denying that any part of their underpayment for 1978 was due to fraud, within the meaning of sec. 6653(b), I.R.C. 1954. Respondent's motion for partial summary judgment denied. *Goodwin v. Commissioner*, 73 T.C. 215 (1979), and *Considine v. Commissioner*, 68 T.C. 52 (1977), overruled.

Steven J. Rosenberg, for the petitioners.
Jeff P. Ehrlich and *Matthew J. Fritz*, for the respondent.

OPINION

TANNENWALD, *Judge*: Deficiencies in petitioners' Federal income taxes having been agreed to and the resultant tax assessed, respondent determined the following additions to petitioners' Federal income taxes:

Taxable year	*Additions to tax sec. 6653(b)*[1]
1976	$743.98
1977	2,299.86
1978	6,905.03

The case is before this Court on respondent's motion for partial summary judgment under Rule 121(b) on the issues of petitioners' understatement of income for the years in issue, petitioners' underpayments of tax for the years in issue, and the addition to tax for 1978. After concessions,[2] the sole issue for our decision is whether petitioner John T. Wright's[3] conviction under section 7206(1) collaterally estops petitioners from denying, for purposes of section 6653(b), that part of their underpayment for 1978 was due to fraud.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue, and all Rule references are to the Rules of Practice and Procedure of this Court.

[2] Respondent has conceded that the additions to tax as to petitioner Susan L. Wright were erroneously determined; petitioners have conceded the existence and amounts of the understatements of income and underpayments of tax for the years in issue.

[3] As this case concerns the addition to tax only as to John T. Wright, see *supra* note 2, we will hereinafter refer to Mr. Wright as "petitioner," and Mr. and Mrs. Wright as "petitioners."

At the time they filed their petition in this case, petitioners maintained their residence in Illiopolis, Illinois. Petitioners filed joint Federal income tax returns for 1976, 1977, and 1978.

Petitioners, in their response to respondent's motion, claim the following: In June 1975, petitioner's father died suddenly, leaving petitioner's mother to run the family farm. Petitioner was asked by his mother to assume responsibility for the farming operation. Prior to June 1975, petitioner had no business or farming experience, and had no training in bookkeeping, accounting, or business management. Petitioner managed the farm through the years in issue, and for purposes of income tax return preparation, turned his records of the farm's receipts and disbursements over to a local accountant skilled in farming bookkeeping methods. Petitioner's wife did not participate in either the farming business or the preparation of petitioners' income tax returns.

On their Federal income tax returns for the years in issue, petitioners understated their taxable income for 1976 by $8,824.46 and their tax table income for 1977 and 1978 by $24,167.18 and $29,904.82, respectively. Petitioners underpaid their Federal income taxes for the years 1976, 1977, and 1978 by $1,487.95, $4,599.72, and $13,810.05, respectively.

Petitioner was indicted in the U.S. District Court, Central District of Illinois, Springfield Division, on March 22, 1982, on two counts of violation of section 7206(1) and two counts of violation of section 7201, one of each of the counts relating to the taxable year 1977 and one of each of the counts relating to the taxable year 1978. On June 15, 1982, that court, based on petitioner's guilty plea, entered a finding of guilty for "the offense(s) of subscribing to a false income tax return as charged in Count 3 of the Indictment, in violation of title 26, U.S.C. sec. 7206(1). Counts 1, 2, and 4 dismissed upon Government Motion." Count 3 of the indictment charged:

> That on or about the 10th day of January 1979, in the Central District of Illinois,
>
> John T. Wright
>
> a resident of Illiopolis, Illinois, did wilfully and knowingly make and subscribe to a United States Individual Tax Return (form 1040) for John T. and Susan L. Wright, which was verified by a written declaration that it was made under the penalties of perjury, and was filed with the Internal Revenue Service, when he did not believe said Income Tax Return to be true and correct as to every material matter in that the Income Tax Return

stated that the grain sale and other income of John T. and Susan L. Wright was $84,665.69 whereas, as he then and there well knew and believed, he had received substantial income in addition to that here before stated.

All in violation of Title 26, United States Code, Section 7206(1).

Respondent issued the deficiency notice on which the instant case is based on September 26, 1983.

Rule 121(a) provides that "Either party may move, with or without supporting affidavits, for a summary adjudication in his favor upon all or any part of the legal issues in controversy." Decision is to be entered for the moving party

if the pleadings, answers to interrogatories, depositions, admissions, and any other acceptable materials, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law. A partial summary adjudication may be made which does not dispose of all the issues in the case.

Rule 121(b). While we must view the facts and inferences to be drawn therefrom in the light most favorable to the party opposing the motion, such party has the burden of setting forth "specific facts showing that there is a genuine issue for trial." Rule 121(d); *Jacklin v. Commissioner*, 79 T.C. 340, 344 (1982).

Respondent bases his motion on the allegedly preclusive effect of petitioner's conviction under section 7206(1)[4] upon the issue of fraud under section 6653(b).[5] Respondent contends that our opinions in *Goodwin v. Commissioner*, 73 T.C. 215 (1979), and *Considine v. Commissioner*, 68 T.C. 52 (1977), compel the conclusion that petitioner's conviction establishes as a matter of law that the underpayment for 1978 was "due to fraud," for purposes of section 6653(b), and thus that respondent's motion should be granted. Petitioners contend that

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[4]Sec. 7206 provides, in relevant part—

Any person who—

(1) DECLARATION UNDER PENALTIES OF PERJURY.—Willfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter; * * *

. . . . . .

shall be guilty of a felony * * *

[5]Sec. 6653(b)(1) provides: "If any part of any underpayment (as defined in subsection (c)) of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of the underpayment."

petitioner's lack of business acumen raises a genuine issue as to a material fact, and that respondent's motion should thus be denied. For the reasons hereinafter stated, we agree with petitioners.

The doctrine of collateral estoppel precludes relitigation of any issue of fact or law that is actually litigated and necessarily determined by a valid and final judgment. *Montana v. United States*, 440 U.S. 147, 153 (1979); see Restatement, Judgments 2d, sec. 27 (1982). Its purpose is to avoid repetitious litigation of issues between the same parties or their privies. See *Jaggard v. Commissioner*, 76 T.C. 222, 223 (1981). The doctrine, however, "must be confined to situations where the matter raised in the second suit is identical in all respects with that decided in the first proceeding and where the controlling facts and applicable legal rules remain unchanged." *Commissioner v. Sunnen*, 333 U.S. 591, 599–600 (1948); see *Cromwell v. County of Sac*, 94 U.S. 351, 353 (1876). Thus, the question is whether the issue under section 6653(b) is "identical in all respects" to that decided under section 7206(1).

Under section 6653(b), respondent has the burden of proving, by clear and convincing evidence, that "any part of any underpayment * * * is due to fraud." See sec. 7454(a); Rule 142(b). The "due to fraud" language has been consistently interpreted to require proof of specific intent to evade a tax believed to be owing. See, e.g., *Hebrank v. Commissioner*, 81 T.C. 640, 642 (1983).[6] Section 7206(1) makes it a crime for one willfully to make and submit any return verified by a written declaration that it is made under the penalties of perjury which he or she does not believe to be true and correct as to every material matter. The indictment on which petitioner's conviction was based charged that he willfully filed a verified return that "he did not believe * * * to be true and correct as to every material matter" in that petitioner "well knew and believed [that] he had received substantial income in addition to" that which he reported.

In *Considine v. Commissioner*, 68 T.C. 52 (1977), a case in which the taxpayer had been convicted under section 7206(1) and was disputing the addition to tax under section 6653(b), we held that "a conviction under section 7206(1) for 'willfully'

[6] See also *Gersh v. Commissioner*, T.C. Memo. 1984–522.

making a return which the taxpayer does not believe to be true and correct is proof that the return is fraudulent," and that the taxpayer was thus "collaterally estopped to deny that he willfully filed a false and fraudulent return." *Considine v. Commissioner, supra* at 61, 68.

Our reasoning in *Considine* was as follows: (1) This Court, in *Amos v. Commissioner*, 43 T.C. 50, 55 (1964), affd. 360 F.2d 358 (4th Cir. 1965), had held that "the term 'willfully' as used in section 7201[7] has authoritatively been defined in prior judicial decisions to encompass all of the elements of fraud which are envisioned by the civil penalty described in section 6653(b)"; (2) the Supreme Court, in *United States v. Bishop*, 412 U.S. 346, 356–361 (1973), had held that "willfully" has the same meaning in each of sections 7201, 7202, 7203, 7204, 7205, 7206, and 7207; therefore, (3) a conviction under section 7206(l) actually and necessarily determined that there was, for purposes of section 6653(b), a specific intention to evade tax. *Considine v. Commissioner, supra* at 59–60. Our opinion in *Considine* and the rationale upon which it was predicated were followed in the Court-reviewed opinion in *Goodwin v. Commissioner*, 73 T.C. 215, 224 (1979), with six Judges dissenting.

Subsequent to our opinions in *Considine v. Commissioner, supra*, and *Goodwin v. Commissioner, supra*, the Court of Appeals for the Ninth Circuit had occasion, in *Considine v. United States*, 683 F.2d 1285, 1287 (9th Cir. 1982), to review the imposition of the addition to tax for fraud on the Considines for the taxable year 1965[8] by the United States District Court on the ground that Mr. Considine's conviction of a violation of section 7206(1) for that year collaterally estopped him from contesting the fraud element of the addition to tax for that year under section 6653(b). The Ninth Circuit disa-

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[7] Sec. 7201 provides, in relevant part—

"Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony."

[8] The interplay between the criminal and civil phases of the Considines' liability for Federal income taxes for the taxable years 1965–67 and 1969 has had the attention of the courts on several occasions. Mr. Considine was convicted under sec. 7206(l) as to his returns for 1965–67 and 1969 (*United States v. Considine*, an unreported case (S.D. Cal. 1973, 34 AFTR 2d 74–5412, 74–2 USTC par. 9639), affd. 502 F.2d 246 (9th Cir. 1973)), and brought three separate actions challenging respondent's subsequent imposition of the additions to tax under sec. 6653(b). *Considine v. Commissioner*, 68 T.C. 52 (1977), concerned the addition for 1969; *Considine v. United States*, 645 F.2d 925 (Ct. Cl. 1981), concerned the additions for 1966 and 1967; and *Considine v. United States*, 683 F.2d 1285 (9th Cir. 1982), concerned the addition for 1965.

greed with the District Court's application of collateral estoppel, and, in so doing, stated flatly that they believed that our opinion in *Considine v. Commissioner, supra*, was incorrect. See 683 F.2d at 1287.[9] Beyond the Ninth Circuit's criticism of our opinion in *Considine v. Commissioner, supra*, it has been held on numerous occasions, both before and after *Considine*, although not in the context of the issue of collateral estoppel, that the intent to evade taxes is not an element of the crime covered by section 7206(1). *United States v. Tsanas*, 572 F.2d 340, 343 (2d Cir. 1978); *United States v. Beasley*, 519 F.2d 233, 245 (5th Cir. 1975); *United States v. DiVarco*, 484 F.2d 670, 673–674 (7th Cir. 1973); *Siravo v. United States*, 377 F.2d 469, 472 n. 4 (1st Cir. 1967); *United States v. Hans*, 548 F. Supp. 1119, 1124 (S.D. Ohio 1982); *United States v. Anderson*, 254 F. Supp. 177, 183–185 (W.D. Ark. 1966); see also *United States v. Whyte*, 699 F.2d 375, 381 (7th Cir. 1983).[10]

Against this background, we have reexamined our opinions in *Goodwin v. Commissioner, supra*, and *Considine v. Commissioner, supra*, and have concluded that they should no longer be followed to the extent that they hold that a conviction under section 7206(1) is equated by way of collateral estoppel with the existence of fraud within the meaning of section 6653(b).

We begin our analysis in support of our conclusion with the word "willfully," as used in section 7206(1). In *United States v. Pomponio*, 429 U.S. 10 (1976), the Supreme Court held that, for purposes of sections 7201–7207, "willfully" "simply means a voluntary, intentional violation of a known legal duty." 429 U.S. at 12; see *United States v. Bishop*, 412 U.S. at 360. This definition says nothing about fraud, and requires nothing more than a specific intention to violate the law. *United States*

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[9]The District Court was nevertheless affirmed on the ground that the Government had in fact carried its burden of proof on the fraud issue under sec. 6653(b) with respect to both Mr. and Mrs. Considine. In *Considine v. United States*, 645 F.2d 925, 928–931 (Ct. Cl. 1981), which involved the Considines' taxable years 1966 and 1967, the Government contended only that the issue of knowing falsification as to the amount of income and deductions should be disposed of on the basis of collateral estoppel, and did not claim that collateral estoppel applied to the issues of intent to evade or existence of an underpayment. See 645 F.2d at 928. The Court of Claims was thus not required to reach the issue which was the fulcrum of our opinions in *Considine* and *Goodwin*. It sustained the Government's limited contention and, like the Court of Appeals for the Ninth Circuit, went on to hold that the Government had in fact carried its burden of proof as to fraud.

[10]We note that respondent has not cited, and our research has not revealed, any authority, other than our opinions in *Considine* and *Goodwin*, that fraud, i.e., intent to evade taxes, is an element of the offense under sec. 7206(1).

v. Pomponio, 412 U.S. at 11–13; see also *United States v. Koliboski*, 732 F.2d 1328, 1331 n. 2 (7th Cir. 1984). In *Bishop*, the Court buttressed its conclusion that "willfully" has this uniform meaning in sections 7201–7207 by noting those statutes' differences from one another, specifically in the express designation of the specific elements of each offense. *United States v. Bishop*, 412 U.S. at 357–360. For example, the Court described the specific element of the offense under section 7201 as the "attempt to evade." *United States v. Bishop*, 412 U.S. at 359. The Court went on explicitly to caution against interpreting the word "willfully," as used in sections 7201–7207, to include this section 7201 element—

> Semantic confusion sometimes has been created when courts discuss the express requirement of an "attempt to evade" in section 7201 as if it were implicit in the word "willfully" in that statute. * * * Greater clarity might well result from an analysis that distinguishes the express elements, such as an "attempt to evade," prescribed by section 7201, from the uniform requirement of willfulness. [*United States v. Bishop*, 412 U.S. at 360 n.8.]

In *Amos v. Commissioner*, *supra*, we equated the element necessary for conviction under section 7201 (i.e., an "attempt to evade") with that essential for the imposition of the civil penalty under section 6653(b) (i.e., an "underpayment * * * due to fraud"). *Amos v. Commissioner*, *supra* at 55. Because the attempt to evade tax is the gravamen of fraud (see, e.g., *Hebrank v. Commissioner*, *supra* at 642), we concluded in *Amos* that a taxpayer convicted under section 7201 of having attempted to evade or defeat a tax for a taxable year is collaterally estopped from denying under section 6653(b) that part of his underpayment for the same year was "due to fraud." Such identity of criminal tax evasion and civil tax fraud for purposes of collateral estoppel has been repeatedly sustained by the courts. See *Gray v. Commissioner*, 708 F.2d 243, 246 (6th Cir. 1983), affg. a Memorandum Opinion of this Court, and cases cited thereat; see also *Plunkett v. Commissioner*, 465 F.2d 299, 305 (7th Cir. 1972), affg. a Memorandum Opinion of this Court. However, to have held, as we did in *Considine v. Commissioner*, *supra*, and *Goodwin v. Commissioner*, *supra*, that a conviction for "willfully" making a false statement in an income tax return within the meaning of section 7206(1) estops a taxpayer from denying that any underpayment made for the year of the return was "due to

fraud" misapplies the principle of collateral estoppel and creates the semantic confusion warned against in *United States v. Bishop, supra.*

In a criminal action under section 7206(1), the issue actually litigated and necessarily determined is whether the taxpayer voluntarily and intentionally violated his or her known legal duty not to make a false statement as to any material matter on a return. See *United States v. Pomponio, supra* at 12; *United States v. Bishop, supra* at 360. The purpose of section 7206(1) is to facilitate the carrying out of respondent's proper functions by punishing those who intentionally falsify their Federal income tax returns (*United States v. Greenberg*, 735 F.2d 29, 31 (2d Cir. 1984); *United States v. DiVarco, supra* at 673), and the penalty for such perjury is imposed irrespective of the tax consequences of the falsification (*Gaunt v. United States*, 184 F.2d 284, 288 (1st Cir. 1950); *United States v. DiVarco*, 343 F. Supp. 101, 103 (N.D. Ill. 1972), aff'd. 484 F.2d 670 (7th Cir. 1973)). As noted above, the intent to evade taxes is not an element of the crime charged under section 7206(1). See cases cited *supra* p. 641. Thus, the crime is complete with the knowing, material falsification, and a conviction under section 7206(1) does not establish as a matter of law that the taxpayer violated the legal duty with an intent, or in an attempt, to evade taxes.

In short, it cannot be said that the combined effect of the Supreme Court's opinions in *United States v. Pomponio, supra*, and *United States v. Bishop, supra*, and our opinion in *Amos v. Commissioner, supra*, is to equate the standards under section 7206(1) with those under section 6653(b); the Supreme Court simply did not engraft the "attempt to evade" language from section 7201 into section 7206(1) by holding that "willfully" has a uniform meaning in sections 7201–7207. See *Considine v. United States*, 683 F.2d at 1287.[11] Thus, to the extent that they give collateral estoppel effect to a conviction under section 7206(1) on the issue of intent to evade tax under section 6653(b), *Considine v. Commissioner, supra*, and *Goodwin v. Commissioner, supra*, are overruled. Of course, a conviction for willful falsification, under section 7206(1), while not disposi-

[11] See also *Rinehart v. Commissioner*, T.C. Memo. 1983-184; *Schmitz v. Commissioner*, T.C. Memo. 1983-482; cf. *Buras v. Commissioner*, T.C. Memo. 1985-26 (sec. 7203).

tive, will be one of the facts to be considered in a trial on the merits.

In the instant case, petitioners argue that we should deny respondent's motion for partial summary judgment because petitioner's lack of business acumen, and not an attempt to evade taxes, was the reason for the underpayments in question, and the factual issue thus raised is a "genuine issue as to any material fact" under Rule 121(b). We agree. The issue of intent, adequately raised by petitioners herein, is clearly one requiring a trial on the merits. See *Oakland Hills Country Club v. Commissioner*, 74 T.C. 35, 39–40 (1980); *Hoeme v. Commissioner*, 63 T.C. 18, 20 (1974); cf. *Considine v. United States*, 683 F.2d at 1288 (intent to evade is "natural inference" from willful underpayment by sophisticated, knowledgeable taxpayer).[12] Thus, on the sole issue before us, i.e., the addition to tax for 1978, respondent's motion for partial summary judgment will be denied.

An appropriate order will be entered.

Reviewed by the Court.

DAWSON, FAY, SIMPSON, STERRETT, GOFFE, CHABOT, NIMS, PARKER, WHITAKER, SHIELDS, HAMBLEN, COHEN, CLAPP, SWIFT, and WRIGHT, *JJ.*, agree with the majority opinion.

WILBUR, JACOBS, and GERBER, *JJ.*, did not participate in the consideration of this case.

KÖRNER, *J.*, dissenting: I respectfully disagree with the conclusion of the majority in this case that petitioner, John T. Wright, is not estopped by his conviction under section 7206(1) to deny that his Federal income tax return for 1978 was false in that he willfully and knowingly omitted income therefrom which he knew should have been reported. That fact was conclusively established by his guilty plea to the indictment under section 7206(1), which contains the specific allegation of willfully and intentionally failing to report income which

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[12] We do not have a sufficient factual foundation in the moving papers to determine that no material issue of fact exists as to the fraud, as the Court of Appeals for the Ninth Circuit and the Court of Claims were able to do in the *Considine* cases before them.

petitioner knew he should have done. He is thus collaterally estopped to deny that fact in the instant case. *Nell v. Commissioner*, T.C. Memo. 1982–228. His guilty plea is as much a conviction as a conviction following a jury trial. *Gray v. Commissioner*, 708 F.2d 243, (6th Cir. 1983), affg. T.C. Memo. 1981–1, cert. denied 466 U.S. ____ (1984).

For this reason, I would conclude that there is no issue of material fact in this case as to whether petitioner's failure to report all his income on his 1978 return was an innocent mistake due to his lack of business acumen. A conviction under section 7206(1) of filing a false return from which income is omitted does not, standing alone, establish the fraudulent intent to evade tax required to support the addition to tax under section 6653(b). However, here the parties have stipulated that petitioner's willful and knowing omission of income from his 1978 return resulted in an underpayment of tax. In my view, petitioner's willfully and knowingly filing a false return for the year 1978, combined with the stipulation of the parties that the willful omission of income from that return resulted in an underpayment of tax, establishes the intent to evade necessary to a determination of the addition to tax under section 6653(b). Based on the holdings and discussions in *Considine v. United States*, 683 F.2d 1285 (9th Cir. 1982); *Considine v. United States*, 645 F.2d 925 (Ct. Cl. 1981); and *Goodwin v. Commissioner*, 73 T.C. 215 (1979), I would grant respondent's Motion for Summary Judgment in this case.

HARRY R. THOMPSON, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 24387–84. Filed April 8, 1985.

P filed petition in Bankruptcy Court under Bankruptcy Code ch. 7, 11 U.S.C. Initial discharge of P-debtor revoked. Prior to final discharge, R issued notice of deficiency and P filed petition in Tax Court. *Held*, revocation of bankruptcy discharge precludes P from filing petition in Tax Court under 11 U.S.C. sec. 362(a)(8). *Held, further*, petition dismissed for lack of jurisdiction. *Held, further*, amount of time in which P may file petition in Tax Court computed.

Harry R. Thompson, pro se.
Diane L. Worland and *Linda A. Dettery*, for the respondent.

OPINION

CANTREL, *Special Trial Judge*: This case is presently before the Court for hearing and consideration of its February 15, 1985, order to show cause why this case should not be dismissed for lack of jurisdiction by virtue of the provisions of 11 U.S.C. sec. 362(a)(8).[1] The case was called for hearing at the motions session of the Court at Washington, D.C., on March 13, 1985.

Respondent, in his notice of deficiency issued to petitioner on April 9, 1984, determined a deficiency in petitioner's 1980 Federal income tax in the amount of $5,170.71. Petitioner was a resident of Indianapolis, Indiana, at the time he filed his petition herein.

The question concerning the Court's jurisdiction arises from petitioner's filing a bankruptcy petition on March 24, 1982, in the United States Bankruptcy Court for the Southern District of Indiana (hereinafter called Bankruptcy Court). On November 23, 1982, Judge Nicholas Sufana of the Bankruptcy Court ordered that petitioner be discharged in bankruptcy. On December 5, 1983, Judge Sufana revoked the November 23, 1982, discharge so that two pending adversary proceedings pertaining to petitioner's bankruptcy suit could be resolved, and he ordered that Mr. Thompson's Case No. IP 82-1122 S remain open until the resolution of these other adversary proceedings.

On February 12, 1985, Judge Sufana issued a final discharge in bankruptcy under 11 U.S.C. chapter 7.[2]

Respondent mailed the notice of deficiency for the calendar year 1980 to petitioner on April 9, 1984. In reply thereto, on July 9, 1984, petitioner filed an improper petition with this Court. On July 27, 1984, the Court ordered petitioner to file a proper amended petition on or before September 27, 1984. Subsequent to the July 27, 1984, order, the Court became aware of an order issued by the Bankruptcy Court pertaining

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[1]This case was assigned pursuant to Delegation Order No. 8 of this Court, 81 T.C. XXV (1983).

[2]This discharge order of Feb. 12, 1985, was virtually identical to that of Nov. 23, 1982. The only difference was the date.

to petitioner's bankruptcy action. On October 18, 1984, we ordered the parties to file reports containing the particulars of petitioner's bankruptcy action and further ordered that the Court's July 27, 1984, order requiring petitioner to file an amended petition be held in abeyance.[3] Then, on December 7, 1984, this Court issued an order for the parties to show cause in writing why this case should not be dismissed for lack of jurisdiction pursuant to 11 U.S.C. sec. 362(a)(8).[4]

Due to the confusion which arose in the parties' reports regarding Mr. Thompson's final date of discharge in bankruptcy, the Court on February 15, 1985, issued its order herein under consideration for the parties to show cause at the March 13, 1985, motions session why this case should not be dismissed for lack of jurisdiction pursuant to 11 U.S.C. sec. 362(a)(8).

When this case was called from the calendar for the Court's motion session no appearance was made by or on behalf of petitioner. However the Court did have before it for its consideration the two reports, which included the order revoking the discharge, submitted by petitioner in compliance with prior court orders. Counsel for respondent appeared and presented argument, at the conclusion of which the Court took the order to show cause under advisement.

Respondent now agrees that this case should be dismissed for lack of jurisdiction under 11 U.S.C. sec. 362(a)(8). We have previously considered the impact of 11 U.S.C. sec. 362(a)(8) in a somewhat different factual context. See *McClamma v. Commissioner*, 76 T.C. 754 (1981).[5] It is clear that this proceeding is governed by the provisions of the Bankruptcy Code, which was codified and enacted as title 11 of the United States Code on November 6, 1978, by Pub. L. 95–598, 92 Stat. 2549, and the amendments made to the Internal Revenue Code by the Bankruptcy Tax Act of 1980, Pub. L. 96–589, 94 Stat. 3389, 26 U.S.C. sec. 1, et seq., which was enacted on December 24, 1980.[6]

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[3]Respondent and petitioner filed their reports on Nov. 27, 1984, and Dec. 3, 1984, respectively.

[4]In response to the Court's Dec. 7, 1984, order respondent filed a report with this Court on Dec. 27, 1984. Respondent abandoned the position taken in this report in his subsequent report filed on Mar. 8, 1985, and at the motions session in Washington, D.C., on Mar. 13, 1985. Consequently, we will not address the merits of respondent's Dec. 27, 1984, report. Petitioner filed his report on Feb. 11, 1985.

[5]See also *Ever Clean Services, Inc. v. Commissioner*, T.C. Memo. 1982–726.

[6]Both the Bankruptcy Code and Bankruptcy Tax Act of 1980 are effective for bankruptcy cases commenced after Oct. 1, 1979.

Section 362(a)(8) of title 11 provides for an automatic stay of "the *commencement* or continuation of a proceeding before the United States Tax Court concerning the debtor." (Emphasis added.) This provision essentially prohibits a debtor-taxpayer from filing a petition in this Court during the imposition of the stay. For an individual taxpayer the automatic stay remains in effect until the bankruptcy case is closed, dismissed, or a discharge is granted or denied.[7] 11 U.S.C. sec. 362(c)(2).

In these circumstances the automatic stay provisions of the Bankruptcy Code precluded petitioner from commencing a proceeding before the Tax Court until after February 12, 1985, the date the Bankruptcy Court granted a final discharge in bankruptcy. The improper petition filed on July 9, 1984, therefore, was filed in violation of the automatic stay provisions at a time when this Court could not acquire jurisdiction over Mr. Thompson. Accordingly, this case must be dismissed.

In order to invoke this Court's jurisdiction to contest his Federal income tax liability for 1980 petitioner must file a new petition. We agree with respondent that petitioner has 150 days from February 12, 1985, to file his petition. Section 6213(f), Internal Revenue Code of 1954, as amended,[8] provides that the running of the time for filing a petition in this Court shall be suspended for a period during which the debtor is prohibited from filing a petition in this Court (90 days under section 6213(a), I.R.C. 1954, as amended) and for 60 days thereafter. Since the bankruptcy proceeding was pending on account of the December 5, 1983, revocation at the time the deficiency notice was issued, the entire 90-day period was stayed. Ninety days plus the 60 days allowed after the automatic stay was lifted yields 150 days.

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[7] Under 11 U.S.C. sec. 362(d), the bankruptcy judge may lift the stay upon request of a party in interest.

[8] Sec. 6213(f) provides—

SEC. 6213(f). COORDINATION WITH TITLE 11.—

(1) SUSPENSION OF RUNNING OF PERIOD FOR FILING PETITION IN TITLE 11 CASES.—In any case under title 11 of the United States Code, the running of the time prescribed by subsection (a) for filing a petition in the Tax Court with respect to any deficiency shall be suspended for the period during which the debtor is prohibited by reason of such case from filing a petition in the Tax Court with respect to such deficiency, and for 60 days thereafter.

(2) CERTAIN ACTION NOT TAKEN INTO ACCOUNT.—For purposes of the second and third sentences of subsection (a), the filing of a proof of claim or request for payment (or the taking of any action) in a case under title 11 of the United States Code shall not be treated as action prohibited by such second sentence.

Although the facts are different here partially because of the revocation of the first discharge, we find that our result is supported by *McClamma v. Commissioner, supra*. In *McClamma*, petitioner-husband filed a petition with the bankruptcy court 17 days after respondent issued a joint notice of deficiency for the 1977 taxable year. Thereafter a petition was filed in this Court. We concluded that the petition, insofar as it pertained to the husband, was filed in violation of the automatic stay provisions of the Bankruptcy Code, 11 U.S.C. sec. 362(a)(8). The Court further added the unexpired portion of the 90-day period provided by section 6213(a) (73 days) to the 60-day period provided by section 6213(f) to determine the time in which petitioner-husband could file a new petition with this Court.

To reflect the foregoing,

An appropriate order will be issued.

ESTATE OF JOSEPH M. CARLI, DECEASED, ROBERT J. CARLI, EXECUTOR, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 21753–81. Filed April 9, 1985.

In 1972, decedent, a California resident, created a revocable trust in which he retained a life estate. Decedent transferred his residence to the trust. On the same day that he created the trust, the decedent executed a pour-over will. In 1974, the decedent and his then fiancee, J, entered into an antenuptial agreement, under which decedent agreed to amend the trust and will to provide J with a life estate in the residence upon his death. J's right to a life estate was conditioned on the parties' being married at decedent's death, and was defeasible in the event that she subsequently remarried. J provided no consideration for the life estate other than that contained in the agreement. Under the agreement, J waived a number of rights she would otherwise have had by virtue of marriage, including her community interest in the decedent's earnings during marriage. Decedent and J, who were then 75 and 73 years of age respectively, married 2 months later and remained married until decedent's death in December 1977. The decedent never amended either the trust or the will prior to his death. J

continued to live in the residence (which was appraised at $89,000 for death tax purposes) until March 1978. At that time, J entered into an agreement with the executor of the decedent's estate, pursuant to which she relinquished her right to a life estate for a consideration of $10,000. On the Federal estate tax return, the estate claimed a marital deduction of $31,423 for the actuarial value of J's life estate in the residence. Petitioner subsequently abandoned this position, and contends that the value of the decedent's interest in the residence should be reduced by the value of J's life estate therein (which petitioner claims is $31,423). In the notice of deficiency, respondent disallowed the claimed $31,423 marital deduction, but allowed the estate a $10,000 deduction under sec. 2053(a)(3), I.R.C. 1954. In his amended answer to the petition, respondent asserts that the allowance of the $10,000 deduction under sec. 2053(a)(3) was erroneous. *Held*, the full value of the residence ($89,000) is includable in the estate under secs. 2036(a) and 2038(a), I.R.C. 1954, without reduction for the value of J's life estate. *Held, further*, J's claim to a life estate under the antenuptial agreement was supported by adequate and full consideration, and therefore the $10,000 payment to J from the estate is deductible under sec. 2053(a)(3), I.R.C. 1954.

Alexander F. Eagle III, for the petitioner.

Rebecca T. Hill, *Eugene H. Ciranni*, and *Dan Henry Lee*, for the respondent.

JACOBS, *Judge*:* By statutory notice of deficiency, respondent determined a deficiency in estate tax in the amount of $7,424. In his amended answer to the petition, respondent claimed a $4,026 increased deficiency; thus, the total amount of estate tax in dispute is $11,450.

Due to concession[1] by petitioner, the issues for decision are:

(1) Whether the value of the decedent's residence, which the decedent transferred to a revocable trust, should be reduced to reflect the surviving spouse's right to a life estate in the residence under an antenuptial agreement.

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*By order of the Chief Judge, this case was reassigned from Judge Edna G. Parker to Judge Julian I. Jacobs for disposition.

[1]Part of the deficiency determined by respondent in the statutory notice, and conceded by petitioner, arose from an adjustment to correct the balances of certain bank accounts included in the gross estate. In reporting these accounts on the estate tax return as taxable transfers under sec. 2035(a), I.R.C. 1954, petitioner erroneously excluded from the account balances the value of the $3,000 annual gift exclusion. Cf. sec. 702(f), Revenue Act of 1978, Pub. L. 95-600, 92 Stat. 2930.

(2) Whether the surviving spouse's right to a life estate under the antenuptial agreement is a claim deductible under section 2053.[2]

FINDINGS OF FACT

The facts have been fully stipulated and are so found. The stipulation, together with joint exhibits, is incorporated herein by this reference and form the basis of the Court's findings of fact.

The decedent, Joseph M. Carli, was born in Italy in 1898 and resided in California from 1899 until his death on December 26, 1977. The decedent died of cancer, with which he had been afflicted since 1969.

The decedent's son, Robert J. Carli (Robert), filed this petition in his capacity as the executor of the decedent's estate. At the time he filed the petition, Robert resided in Santa Clara, California.

A Federal estate tax return was timely filed for the decedent's estate with the Internal Revenue Service Center in Fresno, California, reporting a gross estate of $187,906.

On August 3, 1972, the decedent created a revocable trust, reserving a life estate unto himself. Upon the death of the decedent, the trust estate was to be divided into two trusts, one for the benefit of Robert and the other for the benefit of Robert's children. The decedent transferred to the trust his residence at 1481 Cromwell Drive, Santa Clara, California (the Cromwell residence), by a quitclaim deed, dated August 21, 1972.

On the same day that the trust was created, the decedent executed a will in which he bequeathed all his tangible personal property to Robert and directed that the residue of his estate be added to the corpus of the trust.

On June 21, 1974, in anticipation of marriage, the decedent, then age 75, and Jennie Margaret Downey Whitlatch (Jennie), then age 73, entered into an antenuptial agreement. Pursuant to the antenuptial agreement, each party waived all rights that either would otherwise acquire in the other's property by

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[2] All statutory references are to the Internal Revenue Code of 1954 as in effect at the date of decedent's death, and all Rule references are to the Rules of Practice and Procedure of the Tax Court, except as otherwise noted.

virtue of their marriage, including any rights that would accrue upon death. The agreement further provided that the parties' separate property, whether acquired before or during the marriage, would remain separate property. The agreement delineated which expenses and obligations were to be considered separate liabilities and which were to be treated as joint obligations, and provided that joint obligations were to be paid from a joint bank account to which each would contribute equally.

The agreement further provided that the decedent and Jennie would reside in the Cromwell residence, and that the decedent would amend his will to provide that, upon the death of the decedent, Jennie would have the right to live in the Cromwell residence for the rest of her life, unless she either remarried or relinquished her life estate in the Cromwell residence. The only consideration received by the decedent for Jennie's life estate in the Cromwell residence was that provided under the antenuptial agreement.

On August 10, 1974, the decedent and Jennie were married. At that time, Jennie, a retired teacher, owned property worth more than $150,000 and had a monthly income of $750, which consisted of a pension and social security benefits. The decedent was employed as an automobile service manager throughout 1974, during which time he earned a salary of $12,414.01. The decedent terminated his employment in February of 1976 for health reasons. After the marriage, the decedent did not revise or amend either his will or the trust agreement as he had agreed.

Following the decedent's death in December of 1977, Jennie continued to live in the Cromwell residence, which then had an appraised value of $89,000. In March of 1978, Jennie entered into a "Mutual Settlement and Release Agreement" with Robert individually and as trustee and executor of the decedent's estate. Under the agreement, she relinquished her life estate in the Cromwell residence for a consideration of $10,000.

The California State Controller valued Jennie's life estate in the Cromwell residence at $31,423 for State inheritance tax purposes.

OPINION

The decedent's transfer of the Cromwell residence to the revocable trust on August 21, 1972, constituted a transfer described in sections 2036(a) and 2038(a).[3] On the Federal estate tax return, the estate claimed a marital deduction of $31,423 for the actuarial value of Jennie's life estate in the Cromwell residence. Petitioner subsequently abandoned this position, and now contends that the value of the decedent's interest in the Cromwell residence must be reduced by the value of Jennie's life estate therein (which petitioner claims is $31,423). In the notice of deficiency, respondent disallowed the claimed $31,423 marital deduction,[4] but allowed the estate a $10,000 deduction under section 2053(a)(3) for the payment made to Jennie. In his amended answer to the petition, respondent asserts that the allowance of the $10,000 deduction under section 2053(a)(3) was erroneous.

Petitioner's argument is addressed to the value at which the Cromwell residence is to be included in the gross estate under

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[3] SEC. 2036. TRANSFERS WITH RETAINED LIFE ESTATE.

(a) GENERAL RULE.—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

(1) the possession or enjoyment of, or the right to the income from the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

SEC. 2038. REVOCABLE TRANSFERS.

(a) IN GENERAL.—The value of the gross estate shall include the value of all property—

(1) TRANSFERS AFTER JUNE 22, 1936.—To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.

(2) TRANSFERS ON OR BEFORE JUNE 22, 1936.—To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power during the 3-year period ending on the date of the decedent's death. Except in the case of transfers made after June 22, 1936, no interest of the decedent of which he has made a transfer shall be included in the gross estate under paragraph (1) unless it is includible under this paragraph.

[4] The deduction was disallowed on the ground that the life estate is a terminable interest and therefore nondeductible under sec. 2056(b). Petitioner has conceded in this proceeding that the life estate passing to Jennie does not qualify for the marital deduction.

section 2031.[5] Petitioner maintains that the value of the residence should be discounted or reduced by the value of Jennie's right to a life estate therein under the antenuptial agreement. Petitioner premises his argument on this Court's decision in *Estate of Johnson v. Commissioner*, 77 T.C. 120 (1981), which was reversed on appeal (718 F.2d 1303 (5th Cir. 1983)).

We believe the present case is readily distinguishable from that presented in *Estate of Johnson*. In that case, we held that a surviving spouse's statutory homestead rights in Texas should be treated as a type of restriction or encumbrance that diminished the value at which the decedent's residence was includable in the gross estate. In analyzing the restrictive nature of homestead rights in Texas, the majority noted that the right of life occupancy granted a surviving spouse under the Texas homestead statute was personal to the surviving spouse and therefore distinguishable from a life estate. 77 T.C. at 124 n. 3.

In the present case, the right at issue is not a statutorily created right that attached to the decedent's real property by operation of law, but a right under an antenuptial agreement to a life estate in the marital residence upon the death of the promisor-spouse. Further, Jennie's rights under the agreement did not have the Texas homestead critical features of: (1) Impairment of decedent's ability to convey the property during his life; and (2) exemption of the property from the decedent's creditors either before or after death. We find, therefore, no basis for equating Jennie's rights with the rights at issue in *Estate of Johnson* and accordingly hold that the decision in that case is inapplicable to the present controversy.[6]

Petitioner, in claiming that Jennie's rights under the agreement were a restriction that reduced the fair market value of the Cromwell residence, grafts onto his argument the analysis applicable to the exclusions provided in the parenthetical language of sections 2036(a) and 2038(a) for lifetime transfers

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[5] SEC. 2031. DEFINITION OF GROSS ESTATE.

(a) GENERAL.—The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, whatever situated.

[6] We need not decide at this time whether we concur in the Fifth Circuit's reversal in *Estate of Johnson*.

for adequate and full consideration.[7] As we view the record, the decedent never "transferred" the secondary life estate to Jennie by any instrument of conveyance during his life. The decedent only bound himself contractually to devise the secondary life estate to Jennie. He did not, in fact, amend either his will or the trust agreement. We therefore do not find the parenthetical exclusions under sections 2036(a) and 2038(a) to be applicable.

The issue raised in respondent's amended answer, that of the deductibility of Jennie's rights under the antenuptial agreement, is governed by section 2053. Section 2053(a)(3) authorizes an estate tax deduction for claims against an estate. Respondent argues that the deduction allowed under section 2053 in the notice of deficiency for Jennie's right to a life estate was erroneous because, under local law, Jennie had a "claim to an estate" and not a "claim against the estate." Respondent cites in support of his position *In re Robertson's Estate*, 151 Cal. App. 2d 209, 311 P.2d 573 (1957), which respondent interprets as standing for the proposition that "an antenuptial agreement executed after the last will of the decedent serves as a modification of, and therefore part of, the will of the decedent." We disagree.

In the first place, the *Robertson* court expressly stated that the effect of an antenuptial agreement executed after a will is to withdraw from the application of the will the property disposed of under the agreement. 311 P.2d at 578. And while the court noted that the provision in the agreement by which the decedent promised to bequeath the residue of his estate to his spouse "had the same effect as if it were a clause of the will"[8] (311 P.2d at 579), it explicitly held that the disposition of

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[7] Petitioner neither alleged in the petition nor contended on brief that the doctrine of equitable conversion (which the dissenting opinion herein would apply) applies herein. Since this issue was not properly raised, we need not decide it. Nevertheless, there is some doubt as to whether, under California law, the doctrine of equitable conversion is applicable to a tax controversy. Cf. *Laurel Hill Cemetery Association v. City and Co. of San Francisco*, 81 Cal. App. 2d 371, 184 P.2d 160 (1947).

[8] Part of the controversy in *Robertson* (which was an appeal by the surviving spouse from the probate court's proceeding on the executors' final accounting) centered upon whether the residue of the estate, to which the surviving spouse was entitled under the agreement, was to be subject to debts and administration expenses. The court interpreted the provision of the agreement as "a determination that the properties to which [the surviving spouse] would be entitled *under the agreement* were subject to the charges of administration." 311 P.2d at 579. (Emphasis added.) Thus, as we read the court's opinion, the surviving spouse's rights derived from the agreement and not from the will, and the question to be resolved was the amount due her on her claim, i.e., the gross or net residue.

the residue was not under the residuary clause of the will but under the agreement.

In the second place, we do not believe that such fine points of local law are dispositive of the question herein. As we view the matter, the pivotal question is not whether Jennie received the life estate under the will or under the agreement, but whether the decedent's promise of a life estate was purely gratuitous or whether it was supported by consideration.

The availability of the deduction for claims against an estate is subject to the limitations set forth in section 2053(c)(1). Section 2053(c)(1)(A) provides as follows:

> (A) CONSIDERATION FOR CLAIMS.—The deduction allowed by this section in the case of claims against the estate, unpaid mortgages, or any indebtedness shall, when founded on a promise or agreement, be limited to the extent that they were contracted bona fide and for an *adequate and full consideration in money or money's worth*; except that in any case in which any such claim is founded on a promise or agreement of the decedent to make a contribution or gift to or for the use of any donee described in section 2055 for the purposes specified therein, the deduction for such claims shall not be so limited, but shall be limited to the extent that it would be allowable as a deduction under section 2055 if such promise or agreement constituted a bequest. [Emphasis added].

In determining whether a claim that is founded on an agreement was contracted "for an adequate and full consideration in money or money's worth," section 2053(e) requires that the rule set forth in section 2043(b) must be applied. Section 2043(b) provides that, for the purposes of the estate tax provisions, a consideration "in money or money's worth" does not include an actual or promised relinquishment of "dower or curtesy, or a statutory estate created in lieu of dower or curtesy, or of other marital rights."

Section 804 of the Revenue Act of 1932, 47 Stat. 280, amended section 303(d) of the Revenue Act of 1926, 44 Stat. (Part 2) 73, by adding the language now found in section 2043(b). The purpose of the amendment was to eliminate the estate tax avoidance possible through a contractual conversion of a surviving spouse's statutory rights in the deceased spouse's property into consideration for what would otherwise be a taxable transfer or unallowable deduction:

> This amendment excludes, in determining "consideration in money or money's worth," the value of a relinquished, or a promised relinquishment

of, dower, curtesy, or other marital rights in decedent's property. Section 302(a) and (b) of the 1926 Act require the value of such an interest to be included in the gross estate, and, if its value may, in whole or in part, constitute a consideration for an otherwise taxable transfer (as has been held to be so), or an otherwise unallowable deduction from the gross estate, the effect produced amounts to a subversion of the legislative intent expressed in section 802(a) and (b).

For example, a decedent dies leaving an estate of $1,500,000 (after payment of all charges), and under the State law the surviving spouse is entitled to one-third, or $500,000, of which she cannot be deprived by will without her consent. Under existing law the estate is entitled to no deduction on account of her statutory rights, but, if she and decedent had entered into a contract by which she was to receive from his estate a stated sum in consideration of a waiver of her statutory rights, the amount due her under the contract might be held a deductible claim against the estate as having been contracted for an adequate and full consideration in money's worth, namely, the value of her waived marital rights.

[S. Rept. No 665, 72d Cong., 1st Sess. (1932), 1939–1 C.B. (Part 2) 496, 532.]

Given the legislative purpose underlying section 2043(b), this Court has held that the phrase "other marital rights," for the purposes of determining whether a transfer or a claim was made for "consideration in money or money's worth," embraces those rights conferred upon a surviving spouse by local law upon the death of his or her spouse. *Estate of Ellman v. Commissioner*, 59 T.C. 367, 371–375 (1972); *Estate of Rubin v. Commissioner*, 57 T.C. 817, 824 (1972), affd. without published opinion 478 F.2d 1399 (3d Cir. 1973); *Estate of Glen v. Commissioner*, 45 T.C. 323, 340–342 (1966). This definition does not, however, include any rights a spouse may have by virtue of the marriage in the other spouse's property during their joint lives. *Estate of Ellman v. Commissioner*, *supra*; *Estate of Rubin v. Commissioner*, *supra*; *Estate of Glen v. Commissioner*, *supra*.

In the present case, the availability of the deduction under section 2053(a)(3) for Jennie's claim depends upon whether or not the decedent received "adequate and full consideration in money or money's worth" in exchange for Jennie's life estate. The parties have stipulated that the only consideration exchanged by Jennie for the life estate in the Cromwell residence was that contained in the antenuptial agreement. Because the antenuptial agreement for the most part consists of reciprocal waivers of the rights either party would otherwise have had upon the death of the other (i.e., "marital rights" that do not

constitute "consideration in money or money's worth" under section 2043(b)), we need only consider two of the provisions here.

The first of these is Jennie's waiver of her right to support. As respondent points out in his brief, a provision in an antenuptial agreement that purports to relieve or modify the support obligation imposed upon a spouse by law is generally considered void as against public policy.[9] *Barham v. Barham*, 33 Cal. 2d 416, 202 P.2d 289 (1949). Given that the requirement of "consideration in money or money's worth" for Federal estate tax purposes invokes a higher standard of consideration than that required to establish the validity of a contract under State law (*Estate of Davis v. Commissioner*, 57 T.C. 833, 835 (1972); *Estate of Pollard v. Commissioner*, 52 T.C. 741, 744 (1969); *Estate of Tiffany v. Commissioner*, 47 T.C. 491, 500 (1967); 1 J. Mertens, Law of Federal Gift and Estate Taxation, sec. 5.03 (1959)), we conclude that Jennie's waiver of her support rights, an invalid consideration under California law, clearly does not meet the Federal estate tax requirement. *Ellis v. Commissioner*, 51 T.C. 182 (1968).

Jennie's waiver of the rights she would otherwise have had in her husband's earnings is an altogether different matter. Under California law, a spouse's personal service compensation earned during marriage is community property. Cal. Civ. Code sec. 5108, 5110 (West 1983); e.g., *Thorpe v. Thorpe*, 75 Cal. App. 2d 605, 171 P.2d 126 (1946). Under section 5105 of the California Civil Code, the community interest of one spouse in the earnings of the other is "present, existing and equal." Cal. Civ. Code sec. 5105 (West 1983). However, the parties to an antenuptial agreement may validly waive the community interests that would otherwise accrue in each other's earnings during marriage. E.g., *Barker v. Barker*, 139 Cal. App. 2d 206, 293 P.2d 85 (1956).

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[9] Although our review of California law indicates that the California courts have in the past adhered to the traditional view that any contractual attempts to delimit the parties' support obligations violated the public policy favoring marriage, we note that the decision *In re Marriage of Dawley* 17 Cal. 3d 342, 551 P.2d 323 (1976), would seem to presage a more liberal judicial attitude toward antenuptial agreements that modify marital support obligations.

In the present case, even if we were to assume, arguendo, that parties to an antenuptial agreement could validly modify their support obligations, our determination herein would remain unchanged. Here, the waiver of support rights was reciprocal, and therefore Jennie's waiver of her right to support was not consideration for the decedent's promise to devise a life estate to her under his will.

At the time of the execution of the antenuptial agreement, the decedent was employed as an automobile service manager and earned a salary of $12,414.01 in 1974. Although there is no evidence in the record as to the amount of decedent's earnings in prior and subsequent years, decedent's employment continued until February of 1976. Jennie, on the other hand, was not employed at the time of the marriage. Her income, which consisted of a pension as a retired school teacher and of social security benefits, would not have been community property under California law during the parties' marriage. *In re Marriage of Wilson*, 10 Cal. App. 3d 851, 112 Cal. Rptr. 405 (1974); *In re Marriage of Nizenkoff*, 65 Cal. App. 3d 136, 135 Cal. Rptr. 189 (1976). Thus, in the absence of an agreement, Jennie would have had a present and existing right to one-half of the decedent's earnings, although the decedent would not have acquired any comparable rights in Jennie's income. The decedent thus gave up nothing by his waiver of a community interest in Jennie's income but received a present economic benefit under the agreement through Jennie's waiver of her community interest in his earnings. This benefit, which enured to the decedent during his life, is clearly not the result of the relinquishment of "other marital rights" within the meaning of section 2043(b). *Estate of Ellman v. Commissioner*, *supra*; *Estate of Rubin v. Commissioner*, *supra*; *Estate of Glen v. Commissioner*, *supra*.

Respondent, in his reply brief, argues that Jennie's waiver of her community interest in the decedent's earnings does not constitute consideration for the transfer of the life estate, because, at the time of the execution of the agreement, the decedent and Jennie were not married and therefore Jennie did not then have any community property rights that she could relinquish. In support of his contention, respondent reasons that if no marriage had taken place after the execution of the agreement, then Jennie would have relinquished nothing. Respondent's reasoning, however, overlooks the fact that the entire agreement was executory and conditioned upon the parties' subsequent marriage, and that, if the parties had not married, Jennie would have had no right to a life estate in the Cromwell residence.

Furthermore, we note that a number of courts, in determining whether a particular marital right constituted an excluded

consideration under section 2043(b), have distinguished between a spouse's presently enforceable rights and those rights that are inchoate during the other spouse's life. *Merrill v. Fahs*, 324 U.S. 308, 311, (1945); *Estate of Ellman v. Commissioner*, 59 T.C. at 372; *Estate of O'Nan v. Commissioner*, 47 T.C. 648, 655 (1967); *Estate of Glen v. Commissioner*, 45 T.C. at 339. We believe that, in the case of an antenuptial agreement, the requirement that the marital right relinquished must be a presently enforceable right should be interpreted as requiring that the right must be enforceable during the life of the spouse who benefits by the release or waiver and not, as respondent contends, at the time of the execution of the agreement. *Estate of Glen v. Commissioner*, 45 T.C. at 339. We believe that this view is consistent with both the legislative purpose and well-settled judicial interpretation of section 2043(b).

Having determined that Jennie's waiver of her community interest in the decedent's earnings is not an excluded consideration under section 2043(b), we turn then to the question of whether it was "adequate and full." Respondent contends that a waiver of a spouse's community interest in the other spouse's earnings is not an "adequate and full" consideration because the spouse's interest would not be reducible to money value until termination of the marriage. Cf. secs. 20.2053–4, 20.2043–1, Estate Tax Regs. Respondent bases his conclusion on his observation that the spouse's interest in the other spouse's earnings would change daily. We disagree. In the first place, to the extent that respondent is arguing that a spouse's community interest is only determinable at the termination of the marriage, respondent's contention assumes that the spouse's interest is inchoate during marriage and ignores the express terms of section 5105 of the California Civil Code, which states that a spouse's community interest is "present, existing and equal" during marriage. Cal. Civ. Code sec. 5105 (West 1983); *See v. See*, 64 Cal. 2d 778, 51 Cal. Rptr. 888 (1966). Secondly, the fact that, at the time of the execution of the agreement, a mathematically accurate ascertainment of the present value of Jennie's relinquished community interest in the decedent's earnings would be impossible does not mean that the interest has no value. *Commissioner v. Maresi*, 156 F.2d 929 (2d Cir. 1946), affg. 6 T.C. 582 (1946); *Harrison v. Commissioner*, 17 T.C. 1350 (1952). We therefore conclude that

Jennie's waiver of her community interest in the decedent's earnings was a valuable consideration for Federal estate tax purposes.

Both the Ninth Circuit and this Court have held that the determination of the sufficiency of the consideration is to be made as of the date of the exchange. *United States v. Past*, 347 F.2d 7, 12 (9th Cir. 1965); *Estate of Gregory v. Commissioner*, 39 T.C. 1012, 1021 (1963). While we note that here the record does not contain the evidence that would be necessary to compute and compare the values of Jennie's relinquished community interest and of decedent's promise to devise Jennie a secondary life estate as of the date of the exchange, we also note that this Court has not interpreted the "adequate and full" consideration requirement as necessitating a precise dollar-for-dollar matching of consideration paid with the value of the transferred property. *Estate of O'Nan v. Commissioner*, 47 T.C. 648, 663 (1967). As we pointed out in *Estate of O'Nan*, if we were called upon to determine the income tax consequences to the decedent in the year of the exchange, we would presume the values of the two interests exchanged under the negotiated antenuptial agreement to be equal under the rule set forth in *Philadelphia Park Amusement Co. v. United States*, 130 Ct. Cl. 166, 172, 126 F. Supp. 184, 189 (1954), and endorsed by the Supreme Court in *United States v. Davis*, 370 U.S. 65, 72 (1962).

We believe that the facts of this case, like those in *Estate of O'Nan*, justify applying the *Philadelphia Park* presumption. Jennie and the decedent, who each had comparable financial resources and were then 73 and 75 years of age respectively, were represented by separate counsel in the negotiation of the agreement, and therefore it may be assumed that they bargained at arm's length with respect to their property. At the time that the agreement was negotiated, the decedent was employed but was afflicted with cancer. The decedent's promise of a secondary life estate was conditioned upon the parties' being married at the decedent's death. Given these circumstances, we do not believe that any readily ascertainable value can be attributed to the interests exchanged. We conclude, therefore, that the interest surrendered by Jennie in the decedent's earnings was equivalent in value to the decedent's

promise to devise Jennie a secondary life estate in the Cromwell residence.

Having determined that Jennie's claim under the antenuptial agreement was supported by full and adequate consideration, we hold that the estate is entitled to the deduction for claims authorized by section 2053(a)(3). Respondent in his notice of deficiency determined that the amount allowable as a deduction was $10,000, the amount Jennie received upon relinquishing her life estate approximately 4 months after the decedent's death. Although on brief petitioner contends that the $10,000 payment made to Jennie in exchange for her life estate reflects "personal consideration" rather than the true fair market value of Jennie's claim, petitioner has failed to enlighten us as to the nature of these contentions and has failed to introduce any evidence to support this contention.[10] The burden was on petitioner to prove that respondent's determination was erroneous. Rule 142(a). This he has failed to do. We find, therefore, that respondent's determination in the deficiency notice as to the value of Jennie's claim against the estate must stand.

Decision will be entered for the respondent

Reviewed by the Court.

DAWSON, FAY, SIMPSON, STERRETT, CHABOT, NIMS, PARKER, WHITAKER, COHEN, CLAPP, and SWIFT, *JJ.*, agree with the majority opinion.

WILBUR and GERBER, *JJ.*, did not participate in the consideration of this case.

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[10]The only evidence introduced by petitioner on the valuation issue was the notice of determination of inheritance tax issued by the California State Controller's Office. The notice included Jennie's life estate in the California gross estate at its actuarial value using the 6-percent U.S. life table as required by sec. 13954 of the California Revenue & Taxation Code. Petitioner's description of the valuation as an "arms length competent appraisal" forces us to the conclusion that petitioner does not understand either that the value was derived actuarially and not by appraisal or that the determinations of the California taxing authority with respect to the *California inheritance tax* have no bearing upon the determination of *Federal estate tax* liability.

NIMS, *J.*, concurring: I am in full agreement with the majority, but I think *Estate of Johnson v. Commissioner*, 77 T.C. 120 (1981), revd. 718 F.2d 1303 (5th Cir. 1983), should be expressly overruled in this case.

SIMPSON, CLAPP, and JACOBS, *JJ.*, agree with this concurring opinion.

KÖRNER, *J.*, dissenting: I must respectfully dissent from the majority opinion in this case. In my view, the majority has arrived at an erroneous result here, which is based upon an erroneous analysis of the situation which is presented in this case, and a failure to apply the established law to the correct set of facts.

The facts are relatively simple and were fully stipulated: On August 3, 1972, decedent created a trust, with himself as trustee, which was revocable and which reserved all the life interest to himself. Upon his death, the trust was to become irrevocable and two trusts were created, one for the benefit of his son, and the other for the benefit of his two grandchildren. The decedent's home place in Santa Clara, California (the Cromwell residence), was conveyed to the trust as part of the trust corpus a couple of months thereafter.

On the same date as the creation of the trust, August 3, 1972, decedent executed his will, in which, after making specific provisions for his personalty, he devised and bequeathed all the rest and residue of his estate as a pourover into the inter vivos trust.

Almost 2 years later, on June 21, 1974, and in contemplation of marriage, decedent entered into an antenuptial contract with Jennie Whitlatch (Jennie). That contract provided, inter alia, that Jennie should receive a life estate in the Cromwell property, if decedent predeceased her and if Jennie was still married to him at that time. Thereafter, and prior to her death, Jennie's life estate could be terminated only if she relinquished it or if she should remarry. The contract (clearly conditioned on the parties' subsequently marrying, which they did on August 10, 1974) specifically provided that decedent would amend his will to carry out the provisions of the agreement, *but it also provided (in section 3.07 thereof) that the parties would enter into any other documents which would*

be necessary to carry out the purposes and intentions of the antenuptial agreement.[1]

At the time the antenuptial agreement was executed, decedent had already conveyed the Cromwell property to the trust, so that it was impossible for him to amend his *will* in any way which would give Jennie the agreed life estate therein. The only way the agreement could be carried out was to amend the trust instrument so as to provide for Jennie's life estate, contingent upon her surviving decedent and being married to him at the time of his death. In fact, decedent amended neither his will nor his trust prior to his death on December 26, 1977. On that date, Jennie was still married to decedent, and survived him.

On this set of facts, I would conclude as follows:

The antenuptial agreement was not just a contract to make a will, as the majority appears to hold. It was an executory contract which became operative upon decedent's and Jennie's getting married, and its clear intention was to provide for Jennie a life estate in the Cromwell property, contingent only upon her surviving decedent and being married to him at the date of his death. I think that what was intended here was the immediate creation in Jennie of a contingent future interest in the Cromwell property, both of which contingencies were in fact satisfied at the moment of decedent's death.

The proper way to have carried out this intention was for decedent to have amended the trust instrument to clearly give Jennie her contingent future interest, after decedent and Jennie were married on August 10, 1974. At the moment of decedent's death, the trust instrument would be self-executing, and Jennie's contingent future interest would vest in possession, being terminated only by a later relinquishment by Jennie or by her remarriage, both of which events were under her control. The recital in the antenuptial agreement about decedent's amending his will reflects a confusion either of decedent or his attorney as to what the legal situation was. I do not think that this reference to amending the will should be narrowly construed as nothing more than a contract to make a will (which would be ineffective), especially in view of the obligation in the contract to execute any other documents

[1] The majority fails to find this critical fact, which was an integral part of the antenuptial agreement, a stipulated exhibit in this record.

necessary to carry out the contract provisions. To construe the antenuptial contract in this manner could be viewed as an attempt on the part of decedent to deceive or defraud Jennie of the life estate following decedent's death, *which she clearly contracted for, and which the majority correctly holds was supported by full and adequate consideration.*

Thus, I think the present facts present a clear case for the application of the doctrine of equitable conversion. This ancient and well-known doctrine rests upon the principle that equity regards things which are directed to be done as actually having been done, where nothing has intervened which ought to prevent performance. It is well recognized as the law in California. *Parr-Richmond Industrial Corp. v. Boyd*, 43 Cal. 2d 157, 272 P.2d 16 (1954); *McCaughna v. Bilhorn*, 10 Cal. App. 2d 674, 52 P.2d 1025 (1935). As it applies to the present situation, the application of the doctrine was aptly stated by the Supreme Court of California many years ago:

> When a contract for sale of real property binding on the parties is executed, an equitable conversion is worked; the purchaser of the land is deemed the equitable owner thereof, and the seller is considered the owner of the purchase price. The equitable conversion thus deemed to exist from the time a valid contract of sale is entered into may or may not be absolute. Whether it is, or not, will depend upon whether the terms of the contract of sale are subsequently complied with. If there is no default in that respect, but, on the contrary (and dealing now with the contract involved here), the purchaser performs all the conditions precedent which under the contract entitle him to a conveyance on a given day, he will be deemed on that day to be the owner of the land and the seller to be the owner of the purchase money. The fact that the contracting owner of the land refuses to perform his part of the agreement and make the conveyance to which the purchaser is entitled, on compliance with the contract, cannot affect the status or rights of the parties as to the property.
>
> The purchaser having performed or offered to perform his covenants at the date when the contract called for a conveyance to him, equity considers the property as belonging to him as of that date, and the owner as simply holding the legal title in trust for him. * * *
>
> [*In re Dwyer's Estate*, 159 Cal. 664. ____, 115 P. 235, 240 (1911).]

The equitable conversion takes place at the time when the conveyance should have been made, under the effective contract. This depends upon the contract and the intention of the parties as to when it should be effective. *Baker v. Commissioner of Corporations and Taxes*, 253 Mass. 130, 148 N.E. 593 (1925). When the effectiveness of the contract is subject to the

happening of a future event, the conversion will take place when the contingency occurs, so as to carry out the intention of the parties. *Rockland-Rockport Lime Co. v. Leary*, 203 N.Y. 469, 97 N.E. 43 (1911).

In the instant case, the future event which made the antenuptial contract operative was the marriage of Jennie and decedent. Viewed as a contract for the conveyance of an interest in property, as I think the antenuptial contract should be construed, I think that Jennie had a right to specific performance under California law (*Parr-Richmond Industrial Corp. v. Boyd, supra*; *Utley v. Smith*, 134 Cal. App. 2d 448, 285 P.2d 986 (1955); *In re Dwyer's Estate, supra*). So viewed, it should be held that Jennie, through the doctrine of equitable conversion, had an equitable interest in the Cromwell property—an interest which she had bought and paid for—which was transformed from a future interest to a possessory interest at the moment of decedent's death. What is involved here is simply an interest which Jennie acquired by purchase from decedent in an arm's-length contractual negotiation. Prior to decedent's death, such rights were contingent, but they became fully vested at the moment of his death.

The value of Jennie's life estate should accordingly be excluded from decedent's gross estate under section 2033 and the exception clause of section 2036(a).[2] Applying the appropriate valuation table for a female aged 77 (Jennie's age at the time of decedent's death), in accordance with respondent's regulations, sec. 20.2031–10(c), table A(2), Estate Tax Regs., a factor of .35307 is produced which, when applied to the apparently agreed value of the Cromwell property ($89,000), produces a value of $31,423 for Jennie's life estate.

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[2] Sec. 2036(a) reads as follows:

SEC. 2036(a). GENERAL RULE.—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

It follows that petitioner's amended position herein should be sustained.[3]

GOFFE, SHIELDS, HAMBLEN, and WRIGHT, *JJ.*, agree with this dissent.

BERNARD AND JOYCE MADORIN, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 28963–81. Filed April 11, 1985.

Petitioner was the grantor of four trusts. Because the trustee of the trusts had the power to add beneficiaries, the trusts were grantor trusts pursuant to sec. 674(a), I.R.C. 1954. The trusts purchased limited partnership interests in Metro, which in turn purchased a limited partnership interest in Saintly. Petitioner, as grantor, recognized on his joint income tax return the losses generated by Saintly. At the point Saintly began generating income, the trustee renounced his power to add beneficiaries, and the trusts ceased to be grantor trusts, i.e., they were perfected. *Held*, sec. 1.1001–2(c), example (5), Income Tax Regs., is a valid interpretation of secs. 671, 674, and 1001, I.R.C. 1954, because the grantor is treated as the owner of the trust

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[3] The majority opinion declines to consider the doctrine of equitable conversion as a proper basis for decision in this case, on the grounds that this "issue" was not raised by either party, and, in any event, is of doubtful applicability (see majority opinion note 7). While the majority is clearly entitled to its opinion as to the applicability of the doctrine to the facts of this case, I do not think that it is proper to refuse to consider it at all. No "new issue" is being raised here; the issue is the same, viz, whether Jennie had an interest in the Cromwell residence at the time of decedent's death which was properly excludable from his gross estate. Petitioner claimed that she did; respondent claimed that she did not. Neither side addressed the doctrine of equitable conversion; this is a new legal *theory*, true enough, but it does not change the *issue* between the parties which was properly before the Court. It simply presents a new basis upon which the existing issue can be decided. Nor is the doctrine of equitable conversion to be considered as a "new matter." It does not alter or increase the original deficiency determination, nor does it call for the introduction of any new or different evidence. Cf. *Sorin v. Commissioner*, 29 T.C. 959 (1958), affd. per curiam 271 F.2d 741 (2d Cir. 1959); *Estate of Jayne v. Commissioner*, 61 T.C. 744 (1974), appeal dismissed 7th Cir. (1975); *Achiro v. Commissioner*, 77 T.C. 881 (1981).

If the majority entertains doubt as to whether the doctrine of equitable conversion is properly applicable in this case under controlling California law, as I believe it to be, then it is entirely proper to call on the parties for additional briefing on the subject, given the fact that neither party addressed it at trial or on brief. Rule 151(a). To refuse to consider the theory at all, however, seems to me to be improper on at least two grounds:

(a) It permits the parties, at least by omission, to control the basis upon which this Court decides cases which are presented to it.

(b) To refuse to consider an established legal doctrine of which we are aware, and which may provide the correct basis of decision, simply because neither party has had the wit to address it, is to abdicate our judicial responsibility to decide cases correctly, under the law as we are given the light to see it.

property, and the perfection of the trusts resulted in a taxable disposition of the trust property by petitioner to the trusts. *Held, further*, the Commissioner has authority to apply the regulation retroactively. *Held, further*, the gain recognized is ordinary income pursuant to secs. 741 and 751, I.R.C. 1954.

Stephen N. Engberg and *Michael A. Klein*, for the petitioners.

Judy Jacobs, for the respondent.

OPINION

DAWSON, *Chief Judge*: Respondent determined a deficiency of $27,618 in petitioners' Federal income tax for the taxable year 1978. The issues for decision are: (1) Whether section 1.1001-2(c), example (*5*), Income Tax Regs., should be declared invalid as an unwarranted extension of sections 671, 674, and 1001;[1] (2) if the regulation is valid, whether the regulation should be applied retroactively; and (3) if the regulation is applied retroactively against petitioners, whether the gain recognized by petitioners should be treated as ordinary income or long-term capital gain.

This case was submitted fully stipulated pursuant to Rule 122.[2] The stipulation of facts and the attached exhibits are incorporated herein by this reference. The pertinent facts are summarized below.

Petitioners Bernard and Joyce Madorin were residents of Chicago, Illinois, at the time they filed their petition in this case. On December 19, 1975, Bernard Madorin (petitioner), as grantor, established four separate irrevocable trusts: the Miles Trust; the Mark Trust; the Melanie Trust; and the Bernard Descendant's Trust. The trust agreement designated Richard Coen (Coen) as the trustee of each of the four trusts. Coen was at all times a "nonadverse party" as defined by section 672(b). Further, he was not a "related or subordinate" party as defined by section 672(c). A provision in the trust agreement gave the trustee the power to add one or more section 501(c)(3) charitable organizations as beneficiaries to any of the trusts. As a result of this provision, petitioner, the grantor, was

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the year in question.

[2] All Rule references are to the Tax Court Rules of Practice and Procedure.

treated as the owner of the four trusts pursuant to the provisions of section 674(a).

On or about December 19, 1975, petitioner funded each of the trusts with $5,075 in cash. Petitioners filed United States Quarterly Gift Tax Returns (Forms 709) with respect to the gifts. The $5,075 gift to each trust was its only funding.

On December 19, 1975, each of the four trusts contributed $5,010 to Metro Investment Co. (Metro), an Illinois partnership. The trusts each acquired a one-ninth interest in Metro. On or about December 22, 1975, Metro contributed $45,000 to Saintly Associates (Saintly), a partnership involved in servicing the production of motion pictures. Of the $45,000 invested, approximately $20,000 was attributable to the contributions made by the four trusts. On October 17, 1975, Saintly had entered into an agreement with Warner Bros., Inc., to perform all services necessary to produce a motion picture. To finance the performance of these services, Saintly obtained a nonrecourse loan of $3,270,000 from Security Pacific National Bank.

On petitioners' 1975 through 1977 Federal income tax returns they reported the following losses and income from the four trusts:

1975	Loss	($50,709.60)
1976	Loss	(20,753.92)
1977	Income	1,544.28

On January 1, 1978, Coen, the trustee of the four trusts, irrevocably renounced his power to add beneficiaries to each trust. As a result, the trusts ceased to be grantor trusts and petitioner, the grantor, was no longer considered the owner of the trusts under section 674(a). Petitioners reported no gain or loss from the trusts on their 1978 return.

In August 1981, respondent sent petitioners a notice of deficiency. Relying on section 1.1001–2(c), example (*5*), Income Tax Regs. (hereinafter referred to as example (*5*) or the regulation),[3] respondent determined that the grantor was the

[3]Sec. 1.1001–2(c), example (5), Income Tax Regs., provides:

"In 1975 C, an individual, creates T, an irrevocable trust. Due to certain powers expressly retained by C, T is a 'grantor trust' for purposes of subpart E of part 1 of subchapter J of the Code and therefore C is treated as the owner of the entire trust. T purchases an interest in P, a partnership. C, as owner of T, deducts the distributive share of partnership losses attributable to the partnership interest held by T. In 1978, when the adjusted basis of the partnership interest held by T is $1,200, C renounces the powers previously and expressly retained that initially

owner of the partnership interests, and when the trusts ceased to be grantor trusts, there was a disposition of the trusts' assets, i.e., the partnership interests in Saintly via Metro, by the grantor to the four trusts.[4]

I. Validity of the Regulation

Petitioners contend that example (*5*) is invalid as an unreasonable interpretation of sections 671, 674, and 1001. Petitioners argue that the grantor of a trust should be "treated as the owner" only for the limited purpose of attributing to him items of income, deductions, and credits. This contention embodies petitioners' argument that (1) the trust should be treated as the partner and owner of the partnership interest,

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resulted in T being classified as a grantor trust. Consequently, T ceases to be a grantor trust and C is no longer considered to be the owner of the trust. At the time of the renunciation all of P's liabilities are liabilities on which none of the partners have assumed any personal liability and the proportionate share of which of the interest held by T is $11,000. Since prior to the renunciation C was the owner of the entire trust, C was considered the owner of all the trust property for Federal income tax purposes, including the partnership interest. Since C was considered to be the owner of the partnership interest, C not T, was considered to be the partner in P during the time T was a 'grantor trust.' However, at the time C renounced the powers that gave rise to T's classification as a grantor trust, T no longer qualified as a grantor trust with the result that C was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, C is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor C. On the transfer, C's share of partnership liabilities ($11,000) is treated as money received. Accordingly, C's amount realized is $11,000 and C's gain realized is $9,800 ($11,000 - $1,200)."

[4] Respondent claims petitioners' 1978 taxable income was understated by $49,919.24. (We view as irrelevant the $0.76 difference between this amount and that shown in the schedule accompanying the notice of deficiency.) Such amount was determined in the following manner:

Petitioners' share of Saintly's unrealized receivables via Metro	[5]$52,320.00
Less:	
Petitioners' adjusted basis in Saintly via Metro	[6]2,400.76
Petitioners' realized gain per sec. 1001 and regulations thereunder	49,919.24

[5] Petitioners' share of Saintly's unrealized receivables via Metro was determined as follows:

$3,270,000	Saintly's liability in 1/1/78
× 3.6%	Metro's interest in Saintly
× 4/9	Petitioners' interest in Metro
52,320	

[6] Petitioners' adjusted basis in Saintly via Metro was determined as follows:

$20,000.00	Cash contribution
(50,709.60)	1975 loss
(20,753.92)	1976 loss
1,544 28	1977 income
52,320.00	Partnership liability
2,400.76	

and (2) the trust maintains a separate transactional identity. According to petitioners, the interpretation of "owner" in example (*5*) to mean owner of the trust's assets is inconsistent with section 671. Respondent contends, however, that example (*5*) is a valid interpretation of the applicable statutory provisions. We agree with respondent.

It is well established that regulations "must be sustained unless unreasonable and plainly inconsistent with the revenue statutes." *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948). Section 7805(a) gives the Commissioner broad authority to promulgate needful regulations. See *United States v. Correll*, 389 U.S. 299, 306 (1967). As such, regulations "should not be overruled except for weighty reasons." *Bingler v. Johnson*, 394 U.S. 741, 750 (1969), quoting *Commissioner v. South Texas Lumber, Co., supra* at 501.

We note, however, that "Regulations must, by their terms and in their application, be in harmony with the statute. A regulation which is in conflict with or restrictive of the statute is, to the extent of the conflict or restriction, invalid." *Citizen's National Bank of Waco v. United States*, 417 F.2d 675, 679 (5th Cir. 1969), quoting *Scofield v. Lewis*, 251 F.2d 128, 132 (5th Cir. 1958).

The Supreme Court has ruled that statutory terms should be given their "usual, ordinary and everyday meaning." *Old Colony Railroad Co. v. Commissioner*, 284 U.S. 552, 561 (1932). We agree with respondent's contention that defining "owner * * * of a trust" under section 674 (and section 671) to mean owner of the trust's assets is consistent with the usual, ordinary, and everyday meaning of the word. Application of the grantor trust provisions generally results in nonrecognition of the trust (or a portion thereof) as an entity separate from the grantor. See *Estate of O'Connor v. Commissioner*, 69 T.C. 165, 174 (1977).

Petitioners set forth several arguments toward establishing that "owner" as defined in example (*5*) is inconsistent with the intended meaning of section 671. First, they appeal to the language of section 671. Section 671 states in part:

> Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the

trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. * * *

Petitioners assert that the plain language of section 671 limits the attributes of ownership to the imputation of income, deductions, and credits only. We disagree. There is nothing on the face of the statute which tells us that that is the exclusive attribute of ownership. Section 671 specifies one result of being an "owner," but it does not specifically limit the meaning to that result.

Second, petitioners point to the legislative history of section 671. Petitioners assert that the Senate and House committee reports[5] indicate that Congress intended to limit the attributes of ownership to the reporting of income, deductions, and credits. Petitioners argue that the stated purpose for enacting sections 671 through 679 was to bring together "the rules for determining taxability of trusts falling within the purview of section 22(a) as well as those covered by sections 166 and 167 [of the Internal Revenue Code of 1939]."[6] As such "These provisions generally adopt the approach of the [Clifford] regulations (and the two provisions of existing law)."[7] Petitioners state that prior to 1954, the existing grantor trust rules attributed only income to the grantor. They assert that congressional intent in using the word "owner" was to remedy the preexisting condition by also allowing deductions, losses, and credits attributable to the trust to flow through to the grantor's individual tax return along with the items of income.

We find petitioners' argument to be unpersuasive. The authorities cited in support of petitioners' argument do not specifically state that "owner" was used solely as a device to include items of deductions, losses, and other allowances.[8]

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[5] S. Rept. 1622, 83d Cong., 2d Sess. 364 (1954); H. Rept. 1337, 83d Cong., 2d Sess. A211 (1954).

[6] S. Rept. 1622, *supra* at 364; H. Rept. 1337, *supra* at A211.

[7] S. Rept. 1622, *supra* at 86; H. Rept. 1337, *supra* at 63.

[8] Petitioners cite the following authorities in support of their proposition: II American Law Institute Federal Income Tax Statute, secs. X850-X860 (Feb. 1954 draft), and accompanying explanations; B. Bittker, Federal Income, Estate and Gift Taxation, ch. 80 (1981); Kamin, Surrey & Warren, "The Internal Revenue Code of 1954: Trusts, Estates and Beneficiaries," 54 Colum. L. Rev. 1237 (1954). Petitioners cite one passage from the accompanying explanations to the A.L.I. reports which they believe to be conclusive of the legislative intent:

"The various sections in this subpart provide that "the grantor shall be treated as the owner" of certain portions of a trust. This seems to be the present rule, giving the grantor the trust's deductions. * * * The *Clifford* Regulations, fail to provide that the grantor may take the trust's

Absent a clear and unambiguous legislative directive in this matter, limiting the usage of the word "owner," we will apply the usual, ordinary, and everyday meaning of the word.

Third, petitioners argue that a grantor trust maintains its existence as a transactional entity separate and distinct from its grantor for Federal income tax purposes. In support of their contention, petitioners direct us to several cases. Petitioners' reliance upon these cases is misplaced.

Petitioners rely heavily upon *W & W Fertilizer Corp. v. United States*, 208 Ct. Cl. 443, 527 F.2d 621 (1975), in which the Court of Claims addressed the issue of whether a corporation's subchapter S status was automatically terminated when a shareholder transferred his stock into a grantor trust of which he was the grantor. The Commissioner contended that when the shareholder transferred his stock to the trust, the subchapter S election terminated because having a trust as a shareholder disqualified the corporation as a "small business corporation."[9] The taxpayer, however, argued that a separate trust entity did not exist because the grantor was considered the "owner" of the trust corpus. After examining the language of sections 671 and 1371(a) and their legislative history, the court held that "ownership" extended only to the attribution of income, deductions, and credits from the trust.

In *W & W Fertilizer Corp.*, the court rendered its decision on the basis of the congressional policy inherent in restricting the ownership of subchapter S corporations to individuals and estates. The intent was to provide a narrow benefit to certain classes of taxpayers. A specific requirement of form was established. Hence, when the grantor trust was examined, its specific form rather than the substance was accepted. The court wrote:

> The "grantor trust rules" treat the grantor as if he were the owner in cases where he has reserved to himself some of the powers normally attendant to

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deductions. * * *

"The scope of the ownership rule is provided in section X850 [corresponding to section 671], which extends the rule to credits against tax, so that if a trust receives interest on partially tax-exempt bonds the grantor may use the credit which is provided by section X450. * * *"

[II American Law Institute Federal Income Tax Statute, *supra* at 452.]

We do not find this to be conclusive or convincing proof that Congress intended to use the word "owner" only for the purpose of attributing income, deductions, and credits to the grantor.

[9] Prior to the Tax Reform Act of 1976, a trust was not permitted to be a shareholder of a subch. S corporation under sec. 1371.

outright ownership. Thus, their design is to expand the coverage of the taxing statute. On the other hand, Subchapter S was enacted as a remedial measure to relieve qualifying small business corporations of a tax otherwise payable. Section 1371(a)(2) limits the benefits of the Act to corporations whose stock is owned solely by individuals or estates. Where such a deliberately specific qualification is imposed, we must strictly apply it lest the narrow benefit intended by Congress be unduly broadened. Hence, the "grantor trust rules," with the very purpose of expansion, and the qualification requirements of section 1371(a), with their restrictive purpose, are not analogous, and their comparison is not supportive of the taxpayer in this case. [208 Ct. Cl. at 455; 527 F.2d at 627–628.]

We, therefore, think that *W & W Fertilizer Corp.* has limited applicability. It is an exceptional example where form of ownership controls in order that congressional intent be carried out. We are not concerned in the instant case with a statute that requires that a specific form be satisfied. Moreover, the effect of the decision in *W & W Fertilizer Corp.* is not that the grantor is not considered the owner of the trust corpus for other tax purposes but that there is a disqualification from a benefit that was not intended to be bestowed upon a particular form of ownership.

Petitioners also cite *Swanson v. Commissioner*, 518 F.2d 59 (8th Cir. 1975), affg. T.C. Memo. 1974–61, and *Estate of O'Connor v. Commissioner*, 69 T.C. 165 (1977). We agree with respondent, however, that these cases more aptly support respondent's position than that of petitioners.

In *Swanson v. Commissioner*, *supra*, life insurance policies on the grantor's life were transferred to grantor trusts for valuable consideration. The Commissioner contended that pursuant to section 101(a)(2) each of the trusts was required to recognize as gross income a proportionate amount of the proceeds of the policies that matured upon the grantor's death. The taxpayer claimed that the transfer was to the grantor/insured, and therefore, an exception to section 101(a)(2) had been met. At issue in *Swanson* was whether the trusts and the grantor/insured were the same entity per the definition of "owner" under section 671. While this Court did not directly address this issue, the Eighth Circuit, in its affirmance of our opinion held that "owner" under section 671 meant "owner" in the legal sense of the word, and held that the policies had in fact been transferred to the grantor/insured. The Eighth Circuit declared:

READEX FICHE

> We cannot accept the government's contention that in this case Swanson, the grantor of the grantor-trusts, is not deemed the owner of the trusts for any purpose other than that of taxing trust income to him, and trusts, therefore, retain their identity as a separate tax entity under Section 101(a)(2)(B). [518 F.2d at 63.]

Estate of O'Connor v. Commissioner, *supra*, involved a testamentary marital trust in which the decedent's wife held certain rights which made the trust a grantor trust. Subsequent to the establishment of the trust, the decedent's wife assigned all of her interest in the trust to a section 501(c)(3) charitable foundation. One issue in *Estate of O'Connor* was whether the estate was entitled to a distribution deduction under section 661(a) for amounts passed through the marital trust to the foundation. The resolution of that issue turned upon whether the foundation/grantor should be treated as the "owner." If the foundation were treated as the "owner," then the trust entity would be ignored, and the estate would be deemed to have made its distributions directly to the foundation and not through the trust. This Court held that the trust was not a recognizable tax entity, and disallowed the estate's deduction.[10] In so holding we stated:

> When a grantor or other person has certain powers in respect of trust property that are tantamount to dominion and control over such property, the Code "looks through" the trust form and deems such grantor or other person to be the owner of the trust property and attributes the trust income to such person. See secs. 671, et seq. By attributing such income directly to a grantor or other person, the Code, in effect, disregards the trust entity. [69 T.C. at 174.]

Petitioners also rely upon *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984), wherein the issues were whether the grantor of irrevocable trusts was (1) entitled to a new cost basis when he purchased shares of corporate stock from the trusts, which he originally contributed to the trusts, and (2) entitled to a deduction for interest paid to the trustee on the promissory note used to purchase the stock. The Commissioner contended that the step-up in basis and the interest deduction should be disallowed because the grantor/owner had in effect pur-

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[10] While we specifically limited our analysis to an interplay between sec. 678 and other provisions of subch. J, 69 T.C. at 175 n. 17, we believe that a similar analysis is appropriate in the instant case.

chased the stock from himself and had paid interest to himself. The District Court held for the Commissioner, but the Second Circuit reversed. In reversing the District Court, the Second Circuit wrote:

> Section 671 makes it plain that it was not Congress's intention that the taxation of grantor/"owners" be governed by what might otherwise seem the sensible general principle that a taxpayer may not have meaningful dealings with himself. Rather, the statute envisions (1) that the income and deductions of the grantor and the trust will be computed in the normal fashion, the trust being treated as a fully independent tax-paying entity, and (2) that the relevant "items of income, deductions, and credits against tax" that would ordinarily appear on the trust's return will instead "be included in computing the taxable income and credits of the grantor." * * * Consistently with the objective of *Clifford* to prevent high-bracket taxpayers from shifting income to low-bracket trusts over which they retain or exercise excessive controls, § 671 dictates that, when the grantor is regarded as "owner," the trust's income shall be attributed to him—this and nothing more. [735 F.2d at 709; fn. ref. omitted.]

We need not comment on the result reached by the Second Circuit in *Rothstein*, nor on the rationale applied by the court in reaching such result.[11] In that case, the court was concerned with a trust while it was still in effect, and the court had to decide whether the tax consequences for the taxpayer-grantor were governed by the specific provisions of sections 671 et seq. or whether to apply the general doctrine that he was to be treated as the owner. The court concluded that those consequences were governed by the specific statutory provisions. Since the transaction at issue in that case was different from that at issue in this case, the court was not concerned with the validity of any regulations. However, the case before us involves a significantly different issue. Here, we must decide what are the tax consequences when a grantor trust is terminated as such. There are no specific statutory provisions relating to such a transaction, and we do have a Treasury regulation dealing specifically with the transaction. Under such circumstances, it is not at all clear that the Second Circuit would apply its rationale to those facts, and we believe that our case is entirely distinguishable.

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[11] The Commissioner has recently announced that the Service will not follow the decision in *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984). Rev. Rul. 85-13, 1985-7 I.R.B. 22.

In the instant case, there is an interplay between section 671 and the partnership provisions of subchapter K, along with the recognition of gain or loss provisions of section 1001. These sections require the recognition of gain upon the sale or disposition of a partnership interest where the amount realized exceeds the adjusted basis of the partnership interest. The basis of a partnership interest includes the partner's share of partnership liabilities. Secs. 722 and 752. As the adjusted basis of the partnership interest is often reduced by partnership losses resulting from depreciation and other writeoffs, the goal is to force a recapture upon disposition. This is accomplished by including, as amounts realized, liabilities previously included in basis. *Crane v. Commissioner*, 331 U.S. 1 (1947).

This scheme of taxation is frustrated here if petitioners are allowed to escape recapture through a formalistic, piecemeal application of the law. The trusts were created with a built-in defect, causing them to be grantor trusts. The trusts then invested in a limited partnership interest that produced significant paper losses for the grantor. At the "cross-over" point, when the partnership began to generate income, the defect in the trusts was cured, and the tax burden was placed on the lower bracket beneficiaries. A formalistic approach, as suggested by petitioners, would result in a finding that ownership never changed hands—since the trusts have technically been the owners of the partnership interests—which would then allow petitioners to escape recapture.

Although *Edgar v. Commissioner*, 56 T.C. 717 (1971), was not cited by either party, we think it necessary to comment upon that opinion in light of the instant case. In *Edgar*, we held that a grantor who was also the income beneficiary of a grantor trust could not be treated as the owner of the corpus portion of the trust. Accordingly, we held that the loss generated by a partnership interest owned by the trust was not deductible on the grantor's individual tax return, because the loss belonged to the corpus portion of the trust, while the grantor was owner only of the income portion. The key issue in *Edgar* was the definition of "portion" in section 677. In *Edgar*, was determined that under section 677 a grantor who was also an income beneficiary could only "own" the income portion of the trust. We did not imply in *Edgar* that it was not possible to own the entire trust, i.e., income and corpus. Our previous

cases presuppose this. See, e.g., *Estate of O'Connor v. Commissioner*, 69 T.C. 165 (1977); *Swanson v. Commissioner*, T.C. Memo. 1974–61, affd. 518 F.2d 59 (8th Cir. 1975). See also sec. 1.671–3(a)(1), Income Tax Regs. In the instant case, the trust became a grantor trust by virtue of section 674(a):

> The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

Because the trustee, the nonadverse party, has a power of disposition over all of the corpus and income, the grantor must be considered owner of the whole trust, both income and corpus. *Edgar*, therefore, is distinguishable from the instant case.

Petitioners also contend that even if the grantor is the owner of the trust assets, a mere change in the trust's status is not a disposition triggering the recognition of gain. On brief, petitioners argue that a sale or other disposition did not occur, noting that no transfer documents were ever executed, nor was there any other method of conveyance at the time of trust perfection. While this is true in form, a different event took place in substance.

The situation at hand is analogous to cases dealing with part-sale, part-gift transactions. Under section 1.1001–1(e), Income Tax Regs., if a transfer of property is in part a sale and in part a gift, the transferor must recognize gain to the extent his amount realized exceeds his adjusted basis in the property. This doctrine has been applied by the courts to situations where the transferred gift property is subject to a debt. To the extent the debt assumed by the transferee exceeds the transferor's adjusted basis in the property, a disposition is deemed to occur, and a corresponding gain must be recognized by the transferor. *Estate of Levine v. Commissioner*, 634 F.2d 12 (2d Cir. 1980), affg. 72 T.C. 780 (1979); *Johnson v. Commissioner*, 495 F.2d 1079 (6th Cir. 1974), affg. 59 T.C. 791 (1973). See *Diedrich v. Commissioner*, 457 U.S. 191 (1982). Here, the grantor's proportionate share of the partnership's nonrecourse liability exceeded his adjusted basis in the partnership interest. Therefore, a disposition is deemed to have occurred, and gain must be recognized.

Petitioners finally contend that, applying section 704(e) and section 1.704–1(e)(2), Income Tax Regs., to the facts of the instant case, the trustee of the four trusts is the "partner" for purposes of subchapter K. Petitioners argue that since the grantor is not the partner for purposes of subchapter K, section 741, which governs the recognition of gain or loss by the "transferor partner" in the case of a sale or exchange of the transferor's interest in a partnership, is not applicable in the instant case. Respondent contends that an examination of the ownership tests contained in section 1.704–1(e)(2), Income Tax Regs., is unnecessary and inappropriate in a grantor trust situation. Rather, respondent argues that section 671 et seq. (the grantor trust provisions) and the principle of substance over form result in the grantor's being the owner of the partnership interest.

We do not agree with respondent's contention that an examination of the ownership test of the family partnership rules is inappropriate in a grantor trust situation. Section 1.671–1(c), Income Tax Regs., provides, in part, as follows:

> Except as provided in such subpart E, income of a trust is not included in computing the taxable income and credits of a grantor or another person solely on the grounds of his dominion and control over the trust. However, the provisions of subpart E do not apply in situations involving an assignment of future income, whether or not the assignment is to a trust. * * * *Nor are the rules as to family partnerships affected by the provisions of subpart E even though a partnership interest is held in trust.* * * * [Emphasis added.]

In addition, this Court has noted that the language of section 704(e) is sufficiently broad to cover nonfamily partnership situations even though section 704(e) is primarily directed towards "family partnerships." *Carriage Square, Inc. v. Commissioner*, 69 T.C. 119, 126 n. 4 (1977), citing *Evans v. Commissioner*, 54 T.C. 40, 51 (1970), affd. 447 F.2d 547 (7th Cir. 1971).

We do agree, however, with respondent that the grantor trust provisions result in the grantor's being treated as the owner of the partnership interest. We do not accept petitioners' contention that the application of section 704(e) and the regulations thereunder overrides the grantor trust provisions and necessitates the opposite conclusion.

We do not think that a detailed analysis of the interrelationship of the grantor trust provisions and section 704(e) nor a reconciliation of the various tax principles involved would be helpful in resolving the issues in this case. In general, we think that where there exists a complex arrangement of tiered partnership interests placed in a grantor trust, both subchapter K and subpart E of subchapter J are applicable. In computing income, deductions, and credits of the various taxpayers involved, subchapter K is applied to the partnerships and subpart E operates to tax the grantor on the income, deductions, and credits. Thus in general, the grantor is treated as the owner of the partnership interest for tax purposes. Application of section 704(e) and the regulations thereunder to conclude that the trustee rather than the grantor is the owner of the partnership interest under section 704(e) is ineffective to change this scheme of taxation,[12] because section 704(e) does not operate to override subchapter E.

II. Retroactive Application of the Regulation

Petitioners argue that if example (*5*), is upheld, it should not be applied retroactively. Section 1.1001–2, Income Tax Regs., was promulgated on December 11, 1980, while the grantor trust in the instant case was perfected in 1978.

In the Treasury explanation accompanying the regulation, the Government stated that the regulation would have retroactive effect by reasoning that "these amendments merely clarify the existing regulations by setting forth the long-established ruling and litigating position of the Internal Revenue Service." T.D. 7741, 1981–1 C.B. 430, 431. Petitioners dispute this by pointing out that while the rest of section 1.1001–2, Income Tax Regs., may represent the Government's long-standing litigating position, example (*5*) does not. Petitioners argue that (1) no previous regulation addressed the issue; (2) in several previous cases,[13] the Government argued a position contrary to that taken in example (*5*); and (3) the only

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[12] We noted this result in *Krause v. Commissioner*, 57 T.C. 890, 903 (1972), affd. 497 F.2d 1109 (6th Cir. 1974).

[13] In *W & W Fertilizer Corp. v. United States*, 208 Ct. Cl. 443, 527 F.2d 621 (1975), and *Swanson v. Commissioner*, 518 F.2d 59 (8th Cir. 1975), affg. T.C. Memo. 1974–61, the Service argued that "owner" under sec. 671 meant owner for purposes of income, deductions, and credits—the exact opposite of the position argued by the Service herein.

pronouncement which treats the subject in the same manner as example (5) was promulgated only 3 years previously[14]—hardly a longstanding precedent.

Generally, regulations are applied retroactively unless the Secretary provides otherwise. Sec. 7805(b); *Helvering v. Reynolds*, 313 U.S. 428 (1941); *Wendland v. Commissioner*, 79 T.C. 355 (1982), affd. per curiam 739 F.2d 580 (11th Cir. 1984), affd. sub nom. *Redhouse v. Commissioner*, 728 F.2d 1249 (9th Cir. 1984). The Secretary's failure to limit the retroactive effect of a regulation may not be disturbed unless it amounts to an abuse of discretion. See *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957); *Beneficial Life Insurance Co. v. Commissioner*, 79 T.C. 627 (1982).

We find no abuse of the Secretary's discretion in the instant case. This is not a case where the regulation in question alters settled prior law upon which the taxpayer justifiably relied and the alteration causes the taxpayer to suffer inordinate harm. See *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939); *Wilson v. United States*, 588 F.2d 1168, 1172–1173 (6th Cir. 1978). In fact, respondent's position on the issue in the instant case was published in Rev. Rul. 77–402, 1977–2 C.B. 222, in the year prior to the year in issue. Petitioners were thus aware of respondent's position at the time the trusts were perfected. Accordingly, we uphold the retroactive application of example (5).

III. Capital Gain Versus Ordinary Income

As previously noted, the trusts invested in Saintly via another partnership, Metro. Metro did not have any unrealized receivables or substantially appreciated inventory. Saintly, however, did have unrealized receivables.[15] As a result, respondent determined that the gain on the disposition of the partnership interest by petitioners should be taxed as ordinary income.

Petitioners argue that because the trusts' investments were in Metro, and not in Saintly, directly, the disposition that

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[14]Rev. Rul. 77-402, 1977-2 C.B. 222, is essentially the same as sec. 1.1001-2(c), example (5), Income Tax Regs.

[15]Petitioners do not contest respondent's determination that Saintly has unrealized receivables or their amount. We will, therefore, treat these issues that have not been raised by petitioners, as conceded by them. Rule 34(b)(4).

occurred was a disposition of a partnership interest in Metro, not Saintly. Accordingly, they conclude that the gain should be taxed as capital gain and not ordinary income. We disagree.

Section 741 provides that in the case of a sale or exchange of an interest in a partnership, gain shall be recognized to the transferor and it shall be considered as gain from the sale or exchange of a capital asset, except as provided in section 751. Section 751(a) generally requires ordinary income treatment for the portion of the gain attributable to unrealized receivables or inventory items of the partnership.[16]

Legislative intent in enacting section 751 was "to prevent the conversion of potential ordinary income into capital gain by virtue of transfers of partnership interests."[17] It is clear that had petitioners invested directly in Saintly instead of using Metro as an intermediary, section 751 would have required ordinary income treatment. For purposes of the application of section 751, we see no reason to distinguish between a direct investment in Saintly and an indirect investment through the use of another partnership. To the contrary, to allow petitioners to escape ordinary income treatment would severely restrict the impact of section 751 in a tiered partnership context. Neither the language of section 741 or 751, nor the applicable legislative history supports such a result. Accordingly, the gain on the disposition must be taxed as ordinary income.[18]

Decision will be entered for the respondent.

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[16] SEC. 751(a). SALE OR EXCHANGE OF INTEREST IN PARTNERSHIP.—The amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to—

(1) unrealized receivables of the partnership, or

(2) inventory items of the partnership which have appreciated substantially in value.

shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

[17] S. Rept. 1622, 83d Cong., 2d Sess. 98 (1954); H. Rept. 1337, 83d Cong., 2d Sess. 70 (1954).

[18] Under new sec. 751(f), which was added by the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 595, the result would be the same as we reach herein. Sec. 751(f), which is effective for distributions, sales, and exchanges made after Mar. 31, 1984, in taxable years ending after that date, is not applicable to the instant case. Also, the fact of its enactment does not in any way affect our disposition of this issue. See S. Prt. 98-169, vol. I, at 240 (1984).

CHARLES A. SCOTT AND JAN F. SCOTT, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 18916–82. Filed April 15, 1985.

P, a college professor, also owned and managed five rental properties and operated a chemical analysis business. He used a separate structure located in his backyard as an office to carry on his rental and chemical businesses. *Held:*

1. The separate structure used as an office was "appurtenant to" P's house and therefore constituted part of the dwelling unit for purposes of sec. 280A, I.R.C. 1954.

2. Sec. 280A(c)(5) limits the deductions allocable to the use of the separate structure to the gross income derived from such use; there is no requirement that such gross income be first reduced by the other deductions attributable to the businesses carried on in such structure.

Charles A. Scott and Jan F. Scott, pro se.
Robert M. Ratchford, for the respondent.

SIMPSON, *Judge*: The Commissioner determined a deficiency of $7,923 in the petitioners' Federal income taxes for 1980. After concessions by both parties, the issues for decision are: (1) Whether a separate structure which contained an office and which was on the same property as the petitioner's house was "appurtenant to" such house within the meaning of section 280A(f)(1)(A), I.R.C. 1954[1] and therefore a part of their dwelling unit; and (2) how the gross income limitation of section 280(c)(5) is to be applied to the deductions attributable to the use of such office.

FINDINGS OF FACT

Some of the facts have been stipulated, and those facts are so found.

The petitioners, Charles A. and Jan F. Scott, husband and wife, maintained their residence in New Orleans, Louisiana, at the time they filed their petition in this case. They filed their joint Federal income tax return for 1980 with the Internal Revenue Service Center, Austin, Texas. Mr. Scott will sometimes be referred to as the petitioner.

[1] All statutory references are to the Internal Revenue Code of 1954 as in effect during the year in issue.

During 1980, the petitioners resided at 3949 Elysian Fields Avenue, New Orleans, Louisiana (the property). The petitioners' property was 75 feet wide and approximately 160 feet in depth. On the property were located the petitioners' house, a separate garage with a lean-to, and another separate structure used by Mr. Scott as an office. A fence surrounded three sides of the rear of the property. The office building was located within such fenced area and 12 feet behind the house. There was a separate walkway leading to a gate in the fence and to the office building. The office building consists of four rooms and a bathroom, but contains no sleeping or kitchen facilities.

The property containing the petitioners' house and office building was subject to the same title and the same mortgage. During 1980, the public utilities, taxes, and insurance premiums were charged and paid as a unit for all the buildings on the property. Furthermore, during 1980, the petitioners' house and office building had the same street address. However, in 1983, Mr. Scott applied for and received a new address for the office building of 3947 Elysian Fields Avenue.

During 1980, Mr. Scott was employed as a full-time associate professor of chemistry by Southern University of New Orleans. He was provided an office at the school for his use in connection with his teaching responsibilities.

In 1980, Mr. Scott was also engaged in the trade or business of managing and owning rental properties (the rental business) and the trade or business of chemically analyzing water (the chemical business). The office building was used solely to carry on, on a regular basis, such trades or businesses, and such office building constituted the principal place of business for such trades or businesses.

During 1980, Mr. Scott's total gross income from his chemical business was $385 and from his rental business was $23,123.51. Such gross income consisted of $385 received for services in the chemical business, $6,375 as gross rental income, $11,041.68 as capital gains on the sales of properties (before the allowance of deductions under section 1202), $138.81 as ordinary income from the sales of such properties, and $5,577.02 as interest on mortgages which Mr. Scott acquired in such sales.

Mr. Scott's total expenses arising out of both his chemical and rental businesses which were not allocable to the use of

his office building amounted to $31,986.53. Such expenses included: $725.77 as costs of office supplies, postage, dues, publications, depreciation on laboratory equipment and library, and repairs in connection with his chemical business; $29,825.16 as mortgage interest, repairs, utilities, taxes, advertising, depreciation of rental properties, and legal fees incurred in connection with his rental business; and $1,435.60 as telephone, tools, mileage, depreciation on equipment, and miscellaneous expenses common to all such rental properties.

On their 1980 Federal income tax return, the petitioners claimed total deductions of $1,965.62 for expenses allocable to the use of their office building.[2] The petitioners calculated such deductions in the following manner: (1) For purposes of deducting expenses, the petitioners allocated 25 percent of the expenses incurred for the property during the year; (2) for purposes of depreciating the office building, the petitioners allocated 25 percent of their cost basis in the property to the office building; and (3) for purposes of depreciating those items which were attributable solely to the office building, the petitioners allocated 100 percent of their cost basis in such items. The amounts claimed on the return were:

Taxes	$100.25
Utilities	484.94
Insurance	101.28
Depreciation	
Office building	837.23
Furniture and fixtures acquired prior to 1979	20.00
Furniture and fixtures acquired in July 1979	88.70
New roof on office building	282.28
Iron doors and windows on office building	50.94

In his notice of deficiency, the Commissioner disallowed all of the petitioner's deductions relating to both the chemical and rental businesses on the grounds that the petitioners had not established that any amount constituted an ordinary and

[2]The petitioners did not allocate to the office building any portion of the mortgage interest paid on the property for 1980. However, the petitioners did claim $8,121.50 of mortgage interest paid on the property as an itemized deduction on Schedule A of Form 1040 of their 1980 Federal income tax return.

necessary business expense or was expended for the purpose designated. The Commissioner now concedes in full the deductions for the chemical and rental businesses other than those allocable to the use of the home office. He also concedes that the item of taxes is deductible under section 164(a)(1) regardless of whether there was a qualifying business use of the dwelling unit. See sec. 280A(b). The parties have agreed that if any deductions are allowable for the use of the office building, the allocation method used by the petitioners on their 1980 return is appropriate.

OPINION

The first issue for decision is whether the separate structure which contained an office and which was on the same property as the petitioner's house was "appurtenant to" such house within the meaning of section 280A(f)(1)(A) and therefore is to be treated as part of the dwelling unit.[3] In relevant part, section 280A provides:

> (a) GENERAL RULE.—Except as otherwise provided in this section, in the case of a taxpayer who is an individual * * *, no deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence.
>
> * * * * * * *
>
> (c) EXCEPTIONS FOR CERTAIN BUSINESS OR RENTAL USE; LIMITATION ON DEDUCTIONS FOR SUCH USE.—
>
> (1) CERTAIN BUSINESS USE.—Subsection (a) shall not apply to any item to the extent such item is allocable to a portion of the dwelling unit which is exclusively used on a regular basis —
>
> * * * * * * *
>
> (C) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business.
>
> * * * * * * *
>
> (f) DEFINITIONS AND SPECIAL RULES.—

[3] There was a dispute as to which party bears the burden of proof in this case because of the way the issue developed. However, upon careful consideration, we have decided that we need not rule on such dispute since the record in this case fully supports our conclusions as to the other issues for decision regardless of which party bears the burden of proof

(1) DWELLING UNIT DEFINED.—For purposes of this section—

(A) IN GENERAL.—The term "dwelling unit" includes a house, apartment, condominium, mobile home, boat, or similar property, and *all structures or other property appurtenant to such dwelling unit.* [Emphasis added.]

The petitioners argue that section 280A is inapplicable to the deductions at issue because the office building did not constitute part of a "dwelling unit" within the meaning of such section. They contend that the office building is not appurtenant to their house and that it constitutes a wholly independent office building not associated with their residence. We cannot agree.

The statute does not supply a definition of the term "appurtenant," but we must assume that Congress intended for the term to have its ordinary meaning. Black's Law Dictionary (5th ed. 1979) defines "appurtenant" as "Belonging to; accessory or incident to." Thus, one thing is appurtenant to another thing if it is directly related to the latter although not an essential part of it or not attached to it.

Moreover, section 280A(c)(1) provides certain exceptions to the general rule disallowing deductions for the expenses allocable to a home office, and one of those exceptions is for an office in a separate structure if certain other conditions are satisfied. Sec. 280A(c)(1)(C). Consequently, Congress contemplated that section 280A does apply when the home office is in a separate structure, not attached to the residence. Such application was expressly stated in the committee report, which provides:

the committee amendment provides that a deduction will not be disallowed in the case of a taxpayer who, in connection with his trade or business, uses a separate structure which is not attached to his dwelling unit (e.g., an artist's studio in a structure adjacent to but unattached to his residence). * * * [S. Rept. 94-938 (1976), 1976-3 C.B. (Vol. 3) 49, 186.]

Thus, it is clear that the petitioners' office building may be appurtenant to their house although it is not attached to the house.

In this case, the petitioners' office building is on the same residential lot as the house; the office building is only 12 feet from the house; the office building is behind the house and in an area enclosed by a fence; and all of the expenses for the

property, taxes, utilities, interest, and insurance, were included in common bills. Under these circumstances, we are convinced that there was a close relationship between the office building and the house so that it should be treated as appurtenant to the house and as a part of a dwelling unit subject to the rules of section 280A. The fact that the petitioner subsequently obtained a different address for the office building does not alter this conclusion.

In the alternative, the petitioners argue that if section 280A is applicable to the deductions claimed by them, their office building constitutes a separate structure within the meaning of section 280A(c)(1)(C) and that thus they are not subject to the general disallowance of their deductions under section 280A(a). The Commissioner concedes that the petitioners do qualify under section 280A(c)(1)(C), but he contends that under section 280A(c)(5), they are not entitled to deduct the expenses allocable to their home office. Consequently, the second issue for decision is how the gross income limitation of section 280A(c)(5) is to be applied to the deductions allocable to the use of the office building.[4]

Section 280A(c)(5) provides in pertinent part:

> (5) LIMITATION ON DEDUCTIONS.—In the case of a use described in paragraph (1) * * * the deductions allowed under this chapter for the taxable year by reason of being attributed to such use shall not exceed the excess of—
>
> (A) the gross income derived from such use for the taxable year, over
>
> (B) the deductions allocable to such use which are allowable under this chapter for the taxable year whether or not such unit (or portion thereof) was so used.

The resolution of this issue turns on the meaning of the phrase "gross income derived from such use."

The Commissioner urges us to adopt the interpretation contained in section 1.280A–2(i)(2)(ii) of his proposed regulations (45 Fed. Reg. 52404 (Aug. 7, 1980)[5]), which provides:

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[4] No contention has been made regarding the "exclusively used" requirement of sec. 280A(c)(1). Accordingly, we need not explore this question, and we express no opinion as to the application of the "exclusively used" test to a multiple-use situation.

[5] In 1983, the Commissioner revised his proposed regulations under sec. 280A. 48 Fed. Reg. 33325 (July 21, 1983). The revised proposed regulations rearrange the provisions here at issue but make no significant changes in them. The provision in question is now sec. 1.280A–2(i)(2)(iii) of the proposed regulations.

For purposes of section 280A and this section, gross income derived from use of a unit means gross income from the business activity in the unit reduced by expenditures required for the activity but not allocable to the use of the unit itself, such as expenditures for supplies and compensation paid to other persons. For example, a physician who uses a portion of a dwelling for treating patients shall compute gross income derived from use of the unit by subtracting from the gross income attributable to the business activity in the unit any expenditures for nursing and secretarial services, supplies, etc.

If such interpretation is applied to the facts of this case, the petitioners would not have any gross income derived from the use of their home office during 1980 since the expenses otherwise attributable to the rental and chemical businesses, $31,986.53, exceed the gross income derived from such businesses, $23,517.51. Consequently, if such interpretation is applied to these facts, the petitioners would not be entitled to deduct any of the expenses allocable to the business use of their home office.

Under section 7805(a) and section 301.7805–1(a), Proced. & Admin. Regs., the Commissioner has broad authority to promulgate all needful rules and regulations. *United States v. Correll*, 389 U.S. 299, 306–307 (1967). The Supreme Court has repeatedly declared that Treasury regulations should not be struck down lightly. See, e.g., *Commissioner v. Portland Cement Co. of Utah*, 450 U.S. 156, 169 (1981); *Bingler v. Johnson*, 394 U.S. 741, 749–750 (1969); *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948). The judicial role in assessing the validity of a regulation is necessarily a limited one. In viewing the validity of a Treasury regulation, this Court ordinarily gives deference to the Commissioner's interpretation, and our inquiry is generally limited to the question of whether the regulation implements the congressional mandate in some reasonable manner. *National Muffler Dealers Association, Inc. v. United States*, 440 U.S. 472, 476 (1979); *United States v. Correll*, *supra* at 307.

On the other hand, judicial deference is not a substitute for judicial scrutiny and analysis. *United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 24 (1982); *United States v. Cartwright*, 411 U.S. 546, 550 (1973). A regulation which contradicts the unambiguous language of the statute it purports to interpret cannot stand. *Citizen's National Bank of Waco v. United States*, 417 F.2d 675 (5th Cir. 1969); *CWT Farms, Inc. v. Commissioner*, 79 T.C. 1054, 1062 (1982), affd. 755 F.2d 790

(11th Cir. 1985); *Gresham v. Commissioner*, 79 T.C. 322, 331 (1982), affd. 752 F.2d 518 (10th Cir. 1985). Moreover, where the statute is unambiguous, and there is no valid reason for adding a requirement to those the statute already provides, the Commissioner may not usurp congressional authority by adding such a requirement by regulation. *CWT Farms, Inc. v. Commissioner*, *supra* at 1062, and the cases cited therein. Furthermore, a regulation will be held to be invalid if it is inconsistent with the statute's legislative history and purpose. *United States v. Vogel Fertilizer Co.*, *supra*.

In this case, we are dealing merely with a proposed regulation. As such, it does not reflect the views of the Commissioner following a reconsideration of his proposed rules as a result of an administrative hearing and comments that may have been submitted by interested persons. See 5 U.S.C. sec. 553(c) (1982). In any event, it is clear that the proposed regulation here at issue is not entitled to the judicial deference due final regulations (*Miller v. Commissioner*, 70 T.C. 448, 460 (1978); *F.W. Woolworth Co. v. Commissioner*, 54 T.C. 1233, 1265–1266 (1970)), and in our view, the proposed regulation is inconsistent with the statute. Moreover, the inconsistency is so clear that even if the regulation had been adopted, we would be constrained to hold it invalid.

"Gross income" is a term of art defined in section 61(a) as:

> all income from whatever source derived, including * * * the following items:
> (1) Compensation for services * * *
> (2) Gross income derived from business;
> (3) Gains derived from dealings in property;
> (4) Interest;
> (5) Rents;

Under the statutory scheme, all receipts of income generally constitute gross income.[5] Section 62 introduces the term "adjusted gross income" and provides that it is to be computed by subtracting from gross income certain specified deductions, including deductions for general business expenses, for certain employee business expenses, for losses resulting from the sale

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[5] An exception to this general rule is provided for those taxpayers engaged in the business of manufacturing, merchandising, or mining. In the case of such a business, gross income is computed by taking the gross receipts from sales and subtracting the cost of goods sold. Sec. 1.61–3, Income Tax Regs.

of property, for rental expenses, and for long-term capital gains. Section 63 adds the term "taxable income" and allows deductions for certain other items in the computation of taxable income. Under this arrangement, it is well established that gross income refers to the receipts of a business before the subtraction of the expenses of the business. See *Thompson v. Commissioner*, T. C. Memo. 1984–32; *Umstead v. Commissioner*, T. C. Memo. 1982–573; see also *Stroman v. Commissioner*, 77 T.C. 514, 523 (1981), affd. per curiam 692 F.2d 1 (5th Cir. 1982).

A limitation similar to that contained in section 280A(c)(5) is set forth in section 183, which restricts the deductions allowable with respect to an activity not engaged in for profit. Section 183(b)(1) provides that such deductions are allowable if they would be allowable irrespective of whether the activity is engaged in for profit, and section 183(b)(2) provides that the other deductions attributable to the activity are allowable "but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1)." It is clear that the purpose of such provision is to allow some of the deductions attributable to the activity and that, in applying such limitation, the gross receipts from the activity are to be considered as the limitation on the deductions. See sec. 1.183–1(b)(3), Income Tax Regs. If the business expenses were first subtracted from the income from the business, the purpose of the provision would be defeated. S. Rept. 91–552 (1969), 1969–3 C.B. (Vol. 3) 423, 490.

The Commissioner argues that the statute is ambiguous in that it does not provide a definition of "gross income derived from such use," and he refers to the legislative history to support his interpretation. However, the committee report states in pertinent part:

> In the case where gross income is *derived* both from the business use of the residence or separate unattached structure and from the business use of facilities other than the residence or separate unattached structure a reasonable allocation (based on the facts and circumstances of each case) is to be made to determine that portion of the gross income *derived* from the business use of the residence or separate unattached structure. * * * [S. Rept. 94–938, *supra*, 1976–3 C.B. (Vol. 3) at 187; emphasis added.]

In our view, the committee report makes clear that the phrase "gross income derived from such use" was merely intended to refer to the source of the income and to distinguish the income derived from the business use of a home office from income derived from other sources. For purposes of applying such limitation, income derived from other business activities is to be disregarded.

The effect of the Commissioner's interpretation of section 280A(c)(5) is to provide that the deductions allocable to the business use of a residence are not allowable unless the gross income from the business exceeds all other deductions allocable to such business. The committee report describes the limitation as follows:

> The allowable deductions attributable to the use of a residence or separate unattached structure for trade or business purposes may not exceed the amount of the gross income derived from the use of the residence or separate unattached structure for that trade or business reduced by the deductions which are allowed without regard to their connection with the taxpayer's trade or business (e.g., interest and taxes). * * * With respect to the deductions which are allocable to the trade or business use of the residence or separate unattached structure, deductions allowable without regard to whether the activity is a trade or business are to be deducted first. Any remaining gross income may then be reduced (but not below zero) by the remaining allowable deductions which are allocable to such use. [S. Rept. 94-938, *supra*, 1976-3 C.B. (Vol. 3) at 187.]

The Commissioner's interpretation is, thus, inconsistent with the well-established meaning of the term "gross income," and there is nothing in the legislative history to support his position. The statute and legislative history declare merely that the deductions allocable to the business use of a residence cannot exceed the gross income derived from such use. Under such circumstances, we reject the Commissioner's interpretation, and we hold that the petitioners are entitled to deduct the expenses allocable to the business use of their office building since such expenses do not exceed the gross income derived from such businesses reduced by the deductions allowable without regard to such business use.

Because of other adjustments,

Decision will be entered under Rule 155.

RONALD STRINGER AND ANDREA S. BOUCHER STRINGER, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 26045–82, 3389–83. Filed April 15, 1985.

Petitioners having failed to file a brief, after being directed by the Court to include therein "detailed findings of fact" based upon "specific, detailed, easily found and legible evidence," respondent filed a Motion for Entry of Default Judgment or Dismissal pursuant to Rule 123, Tax Court Rules of Practice and Procedure, with respect to issues upon which petitioners bear the burden of proof. *Held*, under the facts of this case and in the exercise of the Court's discretion, respondent's motion to dismiss those issues pursuant to Rule 123(b) will be granted. *Held, further*, amounts of additional income received by petitioners during the years in issue determined. *Held, further*, petitioners are liable for an addition to tax under sec. 6653(b), I.R.C. 1954, for each of the years in issue.

Arthur P. Tranakos, for the petitioners.
Daniel J. Wiles, for the respondent.

STERRETT, *Judge*: In these consolidated cases, respondent determined by separate notices of deficiency issued to each of petitioners and dated August 2, 1982, that petitioners Ronald Stringer and Andrea Stringer were liable for deficiencies in tax and additions to tax under sections 6651(a) and 6653(a), I.R.C. 1954, for the years 1978 and 1979 in docket No. 26045–82 in the following amounts:

			Addition to tax	
Petitioner	*Year*	*Deficiency*	*Sec. 6651(a)*	*Sec. 6653(a)*
Ronald Stringer	1978	$5,201	$387	$260
	1979	6,410	427	321
Andrea Stringer	1978	271	- - -	14
	1979	4,328	375	216

By separate notices of deficiency issued to each of petitioners and dated November 17, 1982, respondent further determined that petitioners Ronald Stringer and Andrea Stringer were liable for deficiencies in tax and additions to tax under sections 6653(b) and 6654 for the years 1980 and 1981 in docket No. 3389–83 in the following amounts:

Petitioner	Year	Deficiency	Addition to tax Sec. 6653(b)	Addition to tax Sec. 6654
Ronald Stringer	1980	$8,075.00	$4,037.50	$515.56
	1981	14,822.00	7,411.00	1,135.73
Andrea Stringer	1980	4,775.08	2,387.54	381.08
	1981	10,236.00	5,118.00	980.40

After certain concessions by the parties, the remaining issues for decision are (1) whether we should enter a judgment of default or dismissal against petitioners pursuant to Rule 123(a) or Rule 123(b), Tax Court Rules of Practice and Procedure,[1] with respect to issues upon which they bear the burden of proof, and (2) whether respondent has carried his burden of proof with respect to issues upon which he bears the burden of proof.

FINDINGS OF FACT

Some of the facts have been stipulated and those facts are so found to the extent that they represent concessions by the parties of items of income, deductions, or credits. The stipulation of facts and the exhibits attached thereto are incorporated herein by this reference to the same extent. In addition, the Court has made its own findings of fact, but those findings are limited to facts that the Court deems necessary to dispose of respondent's Motion for Entry of Default Judgment or Dismissal pursuant to Rule 123 with respect to issues upon which petitioners bear the burden of proof and to dispose of the issues upon which respondent bears the burden of proof.

At the time they filed their petitions in this case, petitioners, who are husband and wife, resided at 872 Doris Drive in Arnold, Maryland. During the years at issue, Andrea Stringer (hereinafter Andrea) was an assistant professor at Towson State University, and Ronald Stringer (hereinafter Ronald) was an engineer for Bethlehem Steel Shipyards. Andrea had obtained a Ph.D. degree in physical education at the University of Maryland. Ronald had a high school diploma and had further training in shipbuilding and the preparation of publications relating thereto. He also apparently had some college education.

[1] Unless otherwise stated, all Rule references are to the Tax Court Rules of Practice and Procedure.

For the years from at least 1974 through 1977, petitioners filed joint Federal income tax returns disclosing tax liabilities. Petitioners hired tax return preparers to prepare those returns.

For the year 1978, petitioners separately mailed to the Internal Revenue Service (IRS) altered Forms 1040 that contained no financial information with respect to petitioners' tax liabilities. The documents were filled out in a manner that fairly may be described as typical tax protester fashion. Information elicited on the forms was responded to by asterisks. An apparently preprinted statement at the bottom of the forms explained that the asterisks denoted constitutional objections to providing the information elicited. Petitioners had a tax liability payable to the IRS for the year 1978. Their assertions of constitutional objections were frivolous, insincere, and motivated by their contempt for the American system of Federal income taxation. By letters dated June 25, 1979, and July 5, 1979, the IRS advised petitioners that the altered Forms 1040 were not acceptable as income tax returns and requested petitioners to file proper returns. Petitioners initially failed to file income tax returns as requested by respondent, preferring instead to continue asserting frivolous constitutional objections. Eventually, on December 30, 1981, petitioners did file a joint return for 1978. However, that return did not represent an honest attempt to establish correctly their 1978 tax liability, and petitioners were no longer relying on that return by the time their case came to trial.

Although petitioners had tax liabilities payable to the IRS with respect to their 1979, 1980, and 1981 taxable years, petitioners filed no Federal income tax returns for those years prior to the issuance of the statutory notices of deficiency. On May 16, 1984, one day before trial commenced in this case, petitioners filed joint Federal income tax returns for the years 1978 through 1981. The return for 1978 bore little, if any, resemblance to the 1978 return filed in December 1981. None of the returns filed on May 16, 1984, represented honest attempts to establish correctly petitioners' tax liabilities for the years in question. Attached to at least two of those returns were altered Forms W-2 prepared by petitioners' counsel, which varied from the original Forms W-2 received by peti-

tioners. Nothing on the face of the Forms W-2 prepared by petitioners' counsel and attached to the returns suggested that they had been prepared by other than the actual payer of the wages.

Beginning in early 1980 and continuing at least through 1982, Ronald executed and filed with his employer, IRS Forms W-4 falsely claiming on each form that he had incurred no Federal income tax liability for the previous year and anticipated incurring no such liability for the current year. For the periods covered by the exemption certificates, Ronald had Federal income tax liabilities and knew that he had such liabilities. As a result of the false exemption certificates, Ronald's employer did not withhold any Federal income taxes from Ronald's salary for the years 1980 and 1981.

Andrea likewise executed and filed IRS Forms W-4E, falsely claiming to be exempt from Federal income tax withholding. As a result of the false exemption certificates, Andrea's employer did not withhold Federal income taxes from Andrea's salary in 1980 and 1981.

Respondent's agents made diligent attempts to contact and communicate with petitioners in an effort to ascertain petitioners' correct tax liabilities for the years in issue. However, petitioners remained uncooperative throughout the audit phases of this case and engaged in tactics designed to delay and obstruct respondent's determination of their tax liabilities. Respondent was left with no choice but to reconstruct petitioners' income based on whatever records he could locate.

It became apparent after their cases were docketed in this Court, that petitioners planned to assert various and sundry deductions and credits. However, it was equally apparent that the deductions and credits petitioners intended to claim were ill-defined, as witnessed by petitioners' ever-changing, inconsistent, and largely unsupported contentions. In an effort to flesh out petitioners' positions, respondent sought discovery through requests for admissions, interrogatories, and requests for production of documents. Petitioners initially disregarded respondent's attempts at discovery, forcing respondent to pursue court action to compel discovery. Petitioners never responded to respondent's first request for admissions, and the facts recited in that request were incorporated into the parties' stipulation of facts. By order dated July 12, 1983, this Court

ordered petitioners to produce the documents requested in respondent's request for production of documents and to answer the interrogatories served on petitioners. Petitioners did not fairly comply with the Court's order, whereupon respondent filed a motion to impose sanctions. At the initial hearing on that motion, the Court made it clear to petitioners' attorney that the Court was dissatisfied with petitioners' conduct and that it viewed as inexcusable their counsel's purported attempts to comply with the Court's order by turning over to respondent illegible copies of documents. The Court thereafter issued an order dated January 3, 1984, that petitioners serve full and complete answers to respondent's interrogatories and produce all of the documents requested in respondent's documents request. In addition, the Court continued the hearing on respondent's motion to impose sanctions.

Following the Court's order of January 3, 1984, petitioners filed supplemental answers to respondent's interrogatories. The answers were verified as true and correct by both petitioners. In response to questions eliciting information relating to any type of income received by petitioners during the years in question, petitioners relied on information contained in unsigned Forms 1040 for the years in question, which petitioners delivered to respondent. The unsigned Forms 1040 were prepared by an agent of petitioners through the use of certain documents turned over to him by petitioners. The documents used to prepare the Forms 1040 have since been destroyed.

On March 28, 1984, the Court held a hearing on respondent's prior motion to impose sanctions. At that hearing, respondent voiced his objections with respect to the adequacy of petitioners' supplemental answers to respondent's interrogatories. The hearing resulted in an order, dated March 30, 1984, which generally precluded petitioners from contradicting or supplementing their answers to interrogatories. The order further precluded petitioners from introducing into evidence or testifying to any documents not produced to respondent by February 7, 1984.

At the beginning of the trial in this case, the Court, in the interest of giving petitioners every opportunity to present their case, modified the March 30, 1984, order but only to the extent that it precluded petitioners from introducing into

evidence additional documents. That is, the order was not modified to the extent that it precluded petitioners from contradicting or supplementing their answers to interrogatories. As a result of the modification of the order, petitioners literally dumped scores of documents and lists into evidence in a professed effort to establish their entitlement to various deductions and credits. It was abundantly evident to the Court by the end of trial that the record, insofar as it related to the claimed deductions and credits, was hopelessly confused. Accordingly, in ordering opening briefs to be filed on September 17, 1984, and reply briefs to be filed on November 1, 1984, the Court directed petitioners' counsel as follows:

> Mr. Tranakos, you bear a heavy burden in terms of making detailed findings of fact to make your case because the Court is not going to audit all the pieces of paper. It must be directed to specific, detailed, easily found, legible evidence in support of any allegations or proposed findings of fact.

Pursuant to leave granted by the Court prior to the adjournment of the trial, respondent amended his pleadings to conform with the proof presented at trial. In the amended pleadings, respondent increased the determined deficiencies for all of the years in question and asserted an addition to tax for fraud for the years 1978 and 1979. The determined deficiencies and additions to tax set forth in the amended pleadings are in the following amounts:

			Addition to tax		Alternative addition to tax	
Petitioner	*Year*	*Deficiency*	*Sec. 6653(b)*	*Sec. 6654*	*Sec. 6653(a)*	*Sec. 6651(a)*
Ronald and Andrea Stringer[2]	1978	$5,795	$2,898	. . .	$290	$407
Ronald Stringer	1979	8,877	4,439	. . .	444	1,044
Andrea Stringer	1979	6,881	3,441	. . .	344	1,013
Ronald Stringer	1980	10,668	5,334	$681	. . .	. . .
Andrea Stringer	1980	7,168	3,584	457	. . .	. . .
Ronald Stringer	1981	14,902	7,451	1,142	. . .	. . .
Andrea Stringer	1981	10,476	5,238	802	. . .	. . .[3]

[2] Respondent recognizes in his amended answer that petitioners are entitled to the use of joint rates with respect to their 1978 tax liability since they filed a 1978 return on Dec. 30, 1981, prior to the issuance of the notices of deficiency.

[3] We note that at no time did petitioners object to the granting of respondent's motion to amend the pleadings. Nor have they ever commented on the assertions contained in the amended answer. The facts in this case are clearly distinguishable from those in *Gilman v. Commissioner*, 18 B.T.A. 1277 (1930), affd. on another issue 53 F.2d 47 (8th Cir. 1931).

The only amounts of income included for the first time in respondent's amended answer that theretofore had not been stipulated or otherwise agreed to and, therefore, remained in dispute at the end of trial were the amount of consulting income received by Andrea in 1978, the amount of interest income received by both Andrea and Ronald in 1979, and the amount of rental income received by both Andrea and Ronald during 1978 through 1981. The parties have stipulated that petitioners owned rental properties jointly, and evenly divided the gross receipts received therefrom.[4]

Respondent's original statutory notices of deficiency with respect to 1978 did not take into account any consulting or rental income received by the parties. Respondent determined and so asserted in his amended answer that petitioners should have included in their income $1,510 in consulting income and $4,000 in rental income.

Respondent's determination with respect to the amount of consulting income received in 1978 was based on Andrea's testimony at trial and on notations of consulting assignments recorded in a diary kept by Andrea during 1978. Although her testimony was vague and evasive, Andrea indicated that she typically was paid $100 if she performed a full day's consulting work and $50 if she performed a half day's consulting work. Respondent generally multiplied these amounts or lesser amounts by the number of consulting trips that he determined were recorded in Andrea's diary.[5] Respondent became aware of the existence of the diary when Andrea referred to it in a claim for expense deductions. Despite respondent's formal request for all documents evidencing or concerning the receipt of income during the year 1978, the Court order of July 12, 1983, ordering petitioners to produce the requested documents, and a subpoena duces tecum ordering Andrea to produce all diaries maintained by her during 1978–81, Andrea failed to turn the 1978 diary over to respondent until the Court

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[4] Evidently Andrea agrees with respondent's determinations that she received $747 of consulting income in 1979, $200 of consulting income in 1980, and $359 of consulting income in 1981. Respondent took these figures from the unsigned Forms 1040 referred to in the verified interrogatories. The returns filed on the day before trial in this case reflect this much or more consulting income in each of these years. In addition, petitioners admit, by stipulation, the correctness of respondent's determinations with respect to the receipt of a taxable State income tax refund in 1978 and the receipt of interest income in 1978 and 1981.

[5] In some cases, respondent determined that Andrea actually made notations of fees received, and he used the amounts noted in his calculations.

specifically directed her to do so at trial. Andrea admitted at trial that the 1978 diary was the only remaining evidence of the consulting income received in 1978.

During 1978, petitioners received rental income from property known as the Dunkirk Road property. Petitioners resided at that property until March 2, 1978, and then converted it into rental property. A notation of March 6, 1978, in Andrea's diary states "C & P at Dunkirk disconnect/connect." On their 1978 return filed December 30, 1981, petitioners reported $2,860 of gross income from that property. They later contended that they actually received $2,080 of gross income from the property. Both Ronald and Andrea testified in a characteristically vague manner that they thought they charged $260 rental per month. However, a mortgage application sworn to and certified by petitioners under penalties of Federal law in July 1978 indicates a rental figure of $400. Furthermore, a subsequent lease agreement entered into the following year with new tenants of the Dunkirk Road property contained a typewritten monthly rental figure of $400. The typewritten figure was marked through and replaced by a $425 monthly rental figure. Respondent determined, and so asserted in his amended answer, that petitioners received 10 months of rental income at $400 per month in 1978 for a total of $4,000.

Respondent's original statutory notice of deficiency with respect to 1979 did not take into account any interest or rental income received by petitioners.

Petitioners have admitted, by stipulation, that during 1979 they received interest of at least $179.52. In the unsigned 1979 Form 1040 referred to in their verified answers to interrogatories, petitioners indicated that they received interest income of $195. In their 1979 return filed the day before trial in this case, petitioners indicated that they received $175 of interest income. Respondent determined and so asserted in his amended answer that petitioners received total interest income of $195 in 1979.

Petitioners do not dispute that they received rental income during 1979 from three separate properties, the Dunkirk Road property, the Regester Avenue property, and the Murdock Drive property.

The Dunkirk Road property was rented to a Mrs. Smith from January through June 1979. In July 1979, petitioners

signed a lease with new tenants of the Dunkirk Road property. The rental amount was fixed at $425 per month, payable on the first day of each month. The lease term with the new tenants began on August 1, 1979. The new tenants paid a security deposit of $450 at the time they signed the lease. Petitioners have alternatively calculated their 1979 rental income from the Dunkirk Road property to be $2,725 and $3,685, without any credible explanation for either calculation. Respondent determined that petitioners received $4,525 of rental income from the Dunkirk Road property in 1979.[6] In arriving at this figure, respondent used the same $400 monthly rental figure described above with respect to the year 1978 for the first 6 months of the year and the increased $425 monthly rental figure for the last 5 months of the year.

Petitioners rented the Regester Avenue property from March or April 1979 through the end of the year to a Mrs. Gunning. In the unsigned 1979 Form 1040 referred to in their verified answers to interrogatories, petitioners indicated that they received $5,100 of income in 1979 from the Regester Avenue property. At trial, they contended that they actually received only $3,600 of rental income from the property in 1979. Respondent determined that petitioners received $5,100 of rental income from the Regester Avenue property in 1979.

On August 15, 1979, petitioners entered into a written lease with respect to the Murdock Drive property for a period of 1 year from September 1, 1979, through August 1980. The monthly rental on the lease was $365 a month, the first month of which was paid in advance in August 1979. Respondent determined that petitioners received 4 months of rent from the Murdock Drive property in 1979 at $365 per month, for a total of $1,460.[7]

Respondent's original statutory notices of deficiency with respect to 1980 did not take into account any rental income received by petitioners. However, it is uncontroverted that petitioners received rental income during 1980 from three

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[6] In his amended answer, respondent actually asserts that petitioners received a total of $4,050 rental income from the Dunkirk Road property in 1979; however, on brief he reduces that figure to $4,525.

[7] In his amended answer, respondent actually asserts that petitioners received a total of $1,825 rental income from the Murdock Drive property in 1979; however, on brief he reduces that figure to $1,460.

separate properties, the Dunkirk Road property, the Regester Avenue property, and the Murdock Drive property.

The tenants who were living at the Dunkirk Road property at the end of 1979 continued renting the property through September 1980. The rental during this period of time was $425 per month, payable on the first day of each month. When the tenants vacated, they owed petitioners $425 of rent for September and $25 of rent for August. The tenants forfeited their $450 security deposit to pay for their rental obligations. Taking the forfeiture into account, respondent determined that petitioners received 9 full months of rent from the Dunkirk Road property in 1980 at $425 per month, for a total of $3,825.

Mrs. Gunning continued to rent the Regester Avenue property during part of 1980. The property was then rented to a Mrs. Atlas, who resided there through the end of the year. In the unsigned 1980 Form 1040 referred to in their verified answers to interrogatories, petitioners indicated that they received $5,100 of income in 1980 from the Regester Avenue property. At trial, they contended that they actually received only $3,600 of rental income from the property in 1980. Respondent determined that petitioners received $5,100 of rental income from the Regester Avenue property in 1980.

The tenants who were residing at the Murdock Drive property at the end of 1979 continued renting the property through August 1980 for a monthly rental of $365 per month. Petitioners purportedly transferred the Murdock Drive property to a trust for the benefit of their children in May 1980. However, petitioners did not transfer the lease and continued to collect the rent and applied it to the mortgage on the property. Respondent determined that petitioners received 8 full months of rent from the Murdock Drive property in 1980 at $365 per month, for a total of $2,920.

In his original statutory notices of deficiency with respect to 1981, respondent asserted that petitioners received total rental income of $3,500 from the Regester Avenue property to be reported 50 percent by Ronald and 50 percent by Andrea. Mrs. Atlas continued to reside at the Regester Avenue property through June 1981. The property was thereafter rented to a Mr. and Mrs. Manning. The exact monthly rent paid by Mrs. Atlas is not known. Petitioners have admitted that the

Mannings paid rent of $500 per month from August 1, 1981, through the end of the year. Petitioners also have admitted that they received rental income of not less than $3,500 in 1981. In the unsigned 1981 Form 1040 referred to in their verified answers to interrogatories, petitioners indicated that they received $4,275 of rental income in 1981. Respondent determined and so asserted in his amended answer that petitioners actually received total rental income from the Regester Avenue property of $5,750 in 1981.

Petitioners filed no brief whatsoever in this case. On November 13, 1984, respondent filed a Motion for Entry of Default Judgment or Dismissal pursuant to Rule 123 with respect to all issues upon which petitioners bear the burden of proof.

On November 30, 1984, the Court issued an order that petitioners return respondent's Exhibit AP, the 1978 diary maintained by Andrea and relied upon by respondent in establishing the amount of consulting income received in 1978 and the starting date of one of the tenancies in question. At the completion of the trial, petitioners' counsel had withdrawn the diary from the record for the avowed purpose of collaborating with respondent in making copies of the relevant pages. The order specifically stated that, upon petitioners' failure to comply with its terms, the Court would be inclined to impose appropriate sanctions. By letter dated December 12, 1984, petitioners' counsel transmitted to the Court essentially illegible copies of certain pages of respondent's Exhibit AP. This letter offered no explanation for the failure to file a brief.

OPINION

We think it appropriate to stress at the outset, lest our rather sketchy findings of fact fail to portray the situation with which we are faced, that the record in this case borders on being totally unintelligible. We have before us a 598-page transcript, literally scores of exhibits, altered 1978 Forms 1040 announcing frivolous constitutional objections, a delinquent 1978 return filed on December 30, 1981, unsigned Forms 1040 for the years 1978 through 1981, and a final set of Forms 1040 for the years 1978 through 1981 filed 1 day before trial of this case. We place the blame for the confusion squarely with petitioners and their counsel. Without the aid of a brief on

petitioners' behalf containing "detailed findings of fact" based upon "specific, detailed, easily found and legible evidence," as directed by the Court, we are hard pressed to state with anything approaching remote certainty the final of countless inconsistent positions advanced by petitioners. We are absolutely convinced that the tactics employed by petitioners and their counsel were carefully calculated to prevent any meaningful resolution of their case. To the extent that we deal harshly with petitioners, petitioners have only themselves and their counsel to blame.

A. *Disposition of Respondent's Motion*

We will first dispose of respondent's Motion for Entry of Default Judgment or Dismissal pursuant to Rule 123 with respect to all issues upon which petitioners bear the burden of proof.

Rule 151(a) provides, in part, that "Briefs *shall be filed* after trial or submission of a case, except as otherwise directed by the presiding Judge." (Emphasis added.)

Rule 123 provides, in part, as follows:

> (a) Default: When any party has failed to plead or otherwise proceed as provided by these Rules or as required by the Court, he may be held in default by the Court either on motion of another party or on the initiative of the Court. Thereafter, the Court may enter a decision against the defaulting party, upon such terms and conditions as the Court may deem proper * * *
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> (b) Dismissal: For failure of a petitioner properly to prosecute or to comply with these Rules or any order of the Court or for other cause which the Court deems sufficient, the Court may dismiss a case at any time and enter a decision against the petitioner. The Court may, for similar reasons, decide against any party any issue as to which he has the burden of proof; and such decision shall be treated as a dismissal * * *
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> * * * * * * *
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> (d) Effect of Decision on Default or Dismissal: A decision rendered upon a default or in consequence of a dismissal, other than a dismissal for lack of jurisdiction, shall operate as an adjudication on the merits.

Our Rule 151 *requires* that briefs be filed, except as otherwise directed by the presiding Judge. Thus, from the standpoint of the parties, the Rule is not couched in permissive language.

This Court long ago recognized the importance of filing a brief (*Klein v. Commissioner*, 6 B.T.A. 617 (1927)). The taxpayers in the *Klein* case had raised a statute of limitations defense against the alleged deficiencies. Counsel for both parties were expressly requested to submit briefs on the issue; however, no brief was ever filed on behalf of respondent. We commented on respondent's failure to file a brief as follows:

> At the appointed time the brief of counsel for petitioners was filed, but none has been filed in behalf of respondent. We thus have but the argument of one side to consider. Whether we are to assume that the respondent concedes that the statute bars the deficiencies or that he leaves the question to be investigated by the Board without the assistance of counsel is not clear. We reject the latter alternative. It is the duty of counsel to ascertain the considerations and authorities supporting one side or the other and of the Board to judge. [6 B.T.A. at 623.]

The importance of a brief is underscored in a case such as the one currently before us where the contentions advanced by one of the parties are so ill-defined as to be unfathomable by the Court and are supported, if at all, by vague testimony and a mass of incomprehensible documents.

By the end of the rather lengthy trial, the Court was well aware that it would need specific clarification of the deductions and credits petitioners were claiming. To that end, the Court did not rely solely on the existence of Rule 151. It issued an oral directive to petitioners' counsel specifying the type of findings of fact the Court would need to understand petitioners' legal positions. Thus, by failing to file a brief in this case petitioners not only have violated a Rule of this Court but also have disregarded a specific and easily understandable oral directive of the Court. Under the circumstances, we believe that petitioners' inexcusable conduct not only warrants some sanctioning but, in fact, requires it. Petitioners have attempted to shift to the Court the burden of sifting through a 598-page transcript and a large number of exhibits, many of which are suspect in appearance, in order to ferret out petitioners' legal positions and whatever facts may support those positions. We will not accept this burden, nor should we. Our pending docket is well documented, and we can ill afford the time or the manpower to perform duties that properly rest with petitioners.

With respect to the proper means of sanctioning petitioners, respondent has requested that we render a default judgment pursuant to Rule 123(a) or dismiss petitioners' case pursuant to Rule 123(b) to the extent of those issues upon which petitioners bear the burden of proof. We entertain no reservations but that Rule 123 is broad enough to cover respondent's motion, and we can think of no persuasive reason why we, under the circumstances of this case and in the exercise of our discretion, should decline to grant that motion. The failure of petitioners and their counsel to comply with the dictates of Rule 151 and the specific directions of the Court, can be said to constitute a default under Rule 123(a), since they have "failed to * * * proceed as provided by these Rules or as required by the Court." Furthermore, the inactivity of petitioners and their counsel can be said to constitute a failure to properly prosecute pursuant to Rule 123(b), since there has been a "failure * * * to comply with these Rules or any order of the Court."

Although we have located no reported Tax Court case defaulting or dismissing a party for failure to file a brief, we consistently have given Rule 123 broad applicability. Thus, for example, Rule 123 has been applied when a party has refused to appear at trial, to stipulate, or to comply with Court-ordered discovery. See, e.g., *Long v. Commissioner*, 742 F.2d 1141 (8th Cir. 1984), affg. per curiam an order of dismissal by this Court for failure to stipulate; *Miller v. Commissioner*, 654 F.2d 519 (8th Cir. 1981), affg. per curiam an unpublished order of this Court dismissing for failure to stipulate; *Rechtzigel v. Commissioner*, 79 T.C. 132 (1982), affd. per curiam 703 F.2d 1063 (8th Cir. 1983)(refusal to comply with Court-ordered discovery); *Ritchie v. Commissioner*, 72 T.C. 126 (1979) (failure to appear at trial).

There is no question but that Rule 123 may be invoked after, as well as before, a trial has been held. In fact, Rule 123(b) by its very terms authorizes a dismissal "at any time." On numerous occasions, we in essence have defaulted or dismissed issues for failure to brief them. Generally, we have accomplished this result by considering the issue waived or conceded.[8]

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[8] See, e.g., *Stonegate of Blacksburg, Inc. v. Commissioner*, T.C. Memo. 1974-213; *United Contractors, Inc. v. Commissioner*, T.C. Memo. 1964-68, affd. per curiam on other grounds 344 F.2d

Our Rule 123(a) was drafted along the lines of Rule 55(a) and (b), Federal Rules of Civil Procedure. Tax Court Notes to Rules, 60 T.C. 1129. The parameters of Fed. R. Civ. P. 55 were examined in *Alameda v. Secretary of Health, Education & Welfare*, 622 F.2d 1044 (1st Cir. 1980), vacating and remanding 463 F. Supp. 759 (D.P.R. 1979). That case involved the appeal of administrative denials of social security disability benefits. The District Court ordered the Secretary of Health and Human Services to file legal memoranda in support of her administrative decisions. The Secretary, however, failed to do so, whereupon the District Court rendered judgments for the claimants. On appeal, the Government argued that the District Court's action amounted to a default judgment against the United States, prohibited by Fed. R. Civ. P. 55(e).[9]

The First Circuit first upheld the District Court's authority to require a brief and in doing so stated as follows:

> We fully agree with the district court that a government brief is often essential in helping a judge wend his or her way efficiently through a record sometimes dominated by medical specialists' nomenclature. We appreciate the burden processing disability claims places on the Secretary's shoulders, but see no justification in meeting this burden by shifting the task to an unaided district court and the claimant.
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> * * * * * * *
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> The district court has authority to order the Secretary to submit memoranda of law * * *. This authority is an inherent power, "governed not by rule or statute but by the control necessarily vested in courts to manage their own affairs so as to achieve the orderly and expeditious disposition of cases." [622 F.2d at 1046–1047; citations omitted.]

Although the First Circuit ultimately vacated and remanded the District Court's decision for failure to apply properly the unique burden of proof standard set forth in Fed. R. Civ. P. 55(e), the court acknowledged that the Government's failure to contribute a brief required some sanctioning and implicitly recognized that Fed. R. Civ. P. 55(e) would not prohibit a default judgment against the Government for failure to file a brief, so long as the claimant

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123 (4th Cir. 1965). See also *Lysek v. Commissioner*, 583 F.2d 1088 (9th Cir. 1978), cert. denied 439 U.S. 830 (1978), affg. a Memorandum Opinion of this Court holding an issue to be waived when the taxpayers failed to amend their pleadings to conform to the evidence.

[9] Fed. R. Civ. P. 55(e) provides that "No judgment by default shall be entered against the United States or an officer or agency thereof unless the claimant establishes his claim or right to relief by evidence satisfactory to the court."

had established his claim by evidence satisfactory to the court. In addition, the court stated that "Were the Secretary a private litigant, we assume the court could have entered a judgment of default; the Secretary's failure to file the requested memoranda or even explain the failure after months of delay, amounted to a failure under Fed. R. Civ. P. 55(a) to 'otherwise defend' the suit." 622 F.2d at 1048.

Thus, it is clear that the court in *Alameda* recognized the importance of a brief and further recognized that the failure of a party to file a brief may justify, and in some instances require, the entry of a default judgment. As noted, the First Circuit vacated the District Court's decision, based solely on its conclusion that the evidentiary standards set forth in Fed. R. Civ. P. 55(e), for which our Rules contain no counterpart, had not been applied properly by the lower court.

Federal appellate courts also have recognized the importance of appellate briefs. When a brief has been filed, but fails to discuss a particular issue, appellate courts generally have considered the issue waived or conceded. See, e.g., *Harris v. Plastics Manufacturing Co.*, 617 F.2d 438 (5th Cir. 1980). Even if an issue is briefed, an appellate court may consider it waived if the brief makes no page references in the record of authorities for the position advanced. *Wallace v. Hudson-Duncan & Co.*, 98 F.2d 985 (9th Cir. 1938). When a party fails to file a brief altogether, or fails to file a brief complying with Rule 28, Federal Rules of Appellate Procedure, such failure has been held to justify dismissal of the appeal. *Stevens v. Security Pacific National Bank*, 538 F.2d 1387 (1976); *Harrelson v. Lewis*, 418 F.2d 246 (4th Cir. 1969); *Dickson v. Maryland Casualty Co.*, 102 F.2d 299 (5th Cir. 1939).

We conclude that petitioners' failure to file a brief, under the circumstances of this case, fully justifies the dismissal of all issues as to which petitioners have the burden of proof. Accordingly, respondent's motion to dismiss those issues pursuant to Rule 123(b) will be granted.

B. *Disposition of Issues Upon Which Respondent Bears the Burden of Proof*

1. Deficiencies

By amended answer, respondent increased the determined deficiencies for all years in question. Respondent bears the

burden of proof on the increases in deficiencies. Rule 142(a). The only items of income entering into the increased deficiencies that have not been conceded by stipulation or otherwise agreed to are the consulting income received during 1978, the interest income received in 1979, and the rental income received during 1978, 1979, 1980, and 1981.

a. 1978

In determining the consulting income received by Andrea in 1978, respondent relied extensively on his Exhibit AP, the diary maintained by Andrea during that year. As explained in our findings of fact, petitioners' counsel withdrew the exhibit from the record at the completion of trial, and despite a Court order directing him to return the exhibit, he returned only copies of certain pages of the diary, many of which are illegible. To the best of our ability we have attempted to verify respondent's calculation of consulting income based on the copies of Exhibit AP returned by petitioners' counsel. Unfortunately, there are some instances in which we simply are unable to read notations presumably relied upon by respondent, and our inability to do so places us in an unusual posture. Andrea admitted that the diary was the only remaining evidence of her 1978 consulting income. Under the circumstances of this case, we believe that it would be an error to hold that respondent has failed to carry his burden of proof with respect to the amount of consulting income received by Andrea in 1978. In our view, respondent has presented sufficient evidence on this issue to shift the burden of going forward with the evidence to petitioners. Petitioners presented no credible evidence whatsoever to rebut respondent's determination, and petitioners' failure to comply satisfactorily with the Court's order to return Exhibit AP gives rise to the inference that the exhibit, had it been returned, would have been unfavorable to petitioners' case. Therefore, we conclude and so hold that respondent has carried his burden of proving the amount of consulting income received by Andrea in 1978.

Respondent determined that petitioners received 10 months of rental income from the Dunkirk Road property at $400 per month in 1978, for a total of $4,000. The $400 figure is supported by the contemporaneously prepared mortgage application indicating a rental figure of $400 with respect to the

property. Taking inflation into account, the $400 figure is also consistent with the $425 rental charged to the succeeding tenants whose tenancy began during the following year. We found petitioners' testimony that they thought they charged $260-per-month rent totally lacking in credibility and accord it no weight. Respondent, in attempting to establish the starting date of the tenancy, relies on a notation of March 6, 1978, in Andrea's diary stating "C & P at Dunkirk disconnect/connect." Respondent asserts that it is reasonable to infer that the notation establishes the connection of new telephones for the new tenants. Fortunately, we are able to verify the accuracy of this notation from the copies of exhibit AP returned by petitioners' counsel, and under the facts of this case and in the absence of any evidence to the contrary, we believe that the notation serves as sufficient evidence that the tenancy began in March. Based on the foregoing, we conclude and so hold that respondent has carried his burden of proving the amount of rental income received by petitioners in 1978.

b. 1979

Respondent determined that petitioners received total interest income of $195 in 1979. Respondent's determination was apparently based on the information contained in the unsigned 1979 Form 1040 referred to in petitioners' verified answers to interrogatories. Respondent contends that the detailed admissions with respect to the payers of interest and the amounts thereof contained in the answers to interrogatories is the most credible evidence of petitioners' interest income during the year in question. Under the facts of this case, we agree and conclude that respondent's determination must be sustained. By virtue of our March 30, 1984, order, petitioners were precluded from contradicting or supplementing their answers to interrogatories. Although petitioners were relieved of our order to the extent that it precluded them from introducing additional documents, petitioners presented no credible documentation that they received interest income of a reduced amount.[10]

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[10] At trial, petitioners' counsel made some attempt to disassociate the unsigned Forms 1040 from the verified answers to interrogatories, asserting that the Forms 1040 were delivered to respondent separately and were not attached to the answers. To the extent that counsel seeks to persuade us that our Mar. 30, 1984, order should not extend to the unsigned Forms 1040, we flatly reject such a suggestion. The answers to interrogatories clearly and in no uncertain terms incorporated the information contained in those unsigned Forms 1040.

Respondent determined that petitioners received 6 months of rental income from the Dunkirk Road property at $400 per month and 5 months of rental income from that property at $425 per month in 1978, for a total of $4,525. It is unclear, but apparently petitioners only dispute the $400 figure as discussed above in connection with the year 1978, since the $425 figure and the starting date of the new tenancy is established by documents stipulated into evidence. We have already concluded that respondent has satisfied his burden of establishing the $400 figure. Therefore, we conclude and so hold that respondent correctly determined that petitioners received total rental income of $4,525 from the Dunkirk Road property in 1979.

Respondent advances no independent proof of the amount of rental income petitioners received in 1979 from the Regester Avenue property. He relies, instead, on the unsigned 1979 Form 1040 referred to in petitioners' verified answers to interrogatories, wherein petitioners indicated that they received $5,100 of income from the property in 1979. Respondent contends that the admission in the interrogatory answers made from contemporaneous documents turned over to the preparer of the unsigned Form 1040 is clearly the most credible evidence of the receipts from the Regester Avenue property. Although petitioners disavowed the $5,100 figure at trial, they presented no credible evidence to support any reduced figure. By virtue of our order of March 30, 1984, we hold that petitioners received $5,100 of rental income from the Regester Avenue property in 1979.

Respondent determined that petitioners received 4 months of rental income from the Murdock Drive property at $365 per month in 1979 for a total of $1,460. Petitioners agree that they received this amount of rental income from the property in 1979.

c. 1980

Respondent determined that petitioners received 9 months of rental income from the Dunkirk Road property at $425 per month in 1980 for a total of $3,825. It is undisputed that the tenants of the property remained there through September 1980 and that the rental rate was $425 per month. It is also established that the security deposit held by petitioners was

forfeited to pay for part of the August rent and all of September's rent. Taking the forfeiture into account, respondent's calculations are correct, and we therefore hold that petitioners received $3,825 of rental income from the Dunkirk Road property in 1980.

In determining that petitioners received $5,100 of rental income from the Regester Avenue property in 1980, respondent relies on the unsigned Form 1040 for the year 1980 referred to in petitioners' verified answers to interrogatories, wherein petitioners indicated that they received that amount of income from the property in 1980. Although petitioners again disputed this $5,100 figure at trial, as they did with respect to their 1979 rental income from the property, petitioners presented no credible evidence to support any reduced figure. Our conclusion and holding with respect to the effect of the unsigned 1979 Form 1040 on respondent's determination of the amount of rental income received from the Regester Avenue property in 1979 applies equally with respect to the effect of the unsigned 1980 Form 1040 on respondent's determination of the amount of rental income received from the property in 1980. That is, we conclude and so hold that petitioners are bound by the $5,100 figure indicated on the unsigned Form 1040, which was incorporated by reference into their verified answers to interrogatories.

Respondent determined that petitioners received 8 months of rental income at $365 per month in 1980 from the Murdock Drive property for a total of $2,920. Petitioners apparently do not dispute that the property was rented for 8 months at $365 per month during that year. However, they claim that they disposed of that property in May 1980 by conveying it to a trust for the benefit of their children. Respondent disputes the substance of the alleged trust and contends that, even if the trust did have substance, the rental income collected after the alleged conveyance would still be taxable to petitioners because the lease itself was never assigned and petitioners continued to collect the rent and apply it to the payment of their personal liabilities. Although his testimony was vague and often contradictory, when pressed on the question, Ronald admitted that petitioners did not transfer the lease, itself, and that they continued to collect the rent, which they applied to a mortgage on which they were liable. We conclude and so hold

based on these admissions and the inherent incredibility of other contradictory testimony, that petitioners received $2,920 of rental income from the Murdock Drive property in 1980.

d. 1981

Respondent determined that petitioners received a total of $5,750 of rental income from the Regester Avenue Property in 1981. As set forth in our findings of fact, the Regester Avenue property was subject to two different tenancies during 1981. Respondent acknowledges that the relative rental rates are not known, and he has resorted to his own calculations of the probable rates. There is no evidence in the record upon which we could conclude that respondent has carried his burden of proving that petitioners actually received rental income of $5,750 from the Regester Avenue property in 1981. Respondent's case on this particular issue is built on mere speculation. However, petitioners admit that they received some rental income from the property during the year in question. We find the most compelling admission the one contained in the unsigned Form 1040 for the year 1981 referred to in the verified answers to interrogatories, wherein petitioners indicated that they received $4,275 of rental income from the property in 1981. Therefore, we conclude and so hold that petitioners received a total of $4,275 of rental income from the Regester Avenue property in 1981.[11]

2. Addition to Tax for Fraud

Respondent bears the burden of establishing, by clear and convincing evidence, that some part of an underpayment for each year was due to fraud. Section 7454(a); Rule 142(b). Fraud, for purposes of the section 6653(b) addition to tax, has been defined as an intentional wrongdoing with the specific intent to evade a tax believed to be due and owing by conduct intended to conceal, mislead, or otherwise prevent the collection of taxes. *Stoltzfus v. United States*, 398 F.2d 1002, 1004 (3d Cir. 1968); *Powell v. Granquist*, 252 F.2d 56, 60 (9th Cir. 1958). The existence of fraud is a question of fact to be resolved upon consideration of the entire record. *Gajewski v. Commissioner*,

[11] We note that the 1981 Form 1040 filed 1 day before trial in this case actually reports a rental income figure of $4,900. Respondent does not rely on this information and, in fact, acknowledges that the "latest 'returns'" deserve to be totally ignored. We agree with respondent that these latest Forms 1040 fundamentally are lacking in reliability.

67 T.C. 181, 199 (1976), affd. without published opinion 578 F.2d 1383 (8th Cir. 1978).

The record in this case is replete with indicia of fraud, and the conclusion that petitioners engaged in a course of conduct intended to conceal their taxable income for the years 1978, 1979, 1980, and 1981 is inescapable.

The evidence reveals that both petitioners were educated. They were both aware of the responsibility of filing proper income tax returns, and in fact filed returns for the years preceding the years in issue. However, petitioners filed a form not constituting a return for 1978 and initially failed to file any returns whatsoever for the succeeding 3 years. Although petitioners eventually filed returns for the years in question, we have concluded and found as a fact that the making of those returns did not represent an honest attempt to determine correctly their taxes. Attached to at least two of those returns were altered Forms W-2 prepared by petitioners' counsel.[12] For some of the years in question, petitioners knowingly filed false Forms W-4 or W-4E claiming to be exempt from withholding and certifying their lack of tax liability. Failure to file returns is not conclusive evidence of

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[12] In this connection, the following portion of the trial transcript fairly can be called startling.

MR. WILES: Your Honor, I would like to flush this out a little bit. Is it Mr. Tranakos's testimony that he and not the employer prepared a W-2?

MR. TRANAKOS: Oh, yes. Where is it?

(Pause while locates document)

Yes. That is—show it to me.

MR. WILES: Here it is.

(Counsel shows document to Mr. Tranakos)

MR. TRANAKOS: That document was prepared by our office, Your Honor. It was not prepared by the State of Maryland or whoever it was so that is correct.

THE COURT: I don't understand, Mr. Tranakos. Did you prepare something that purports to be a W-2?

MR. TRANAKOS: It is on a W-2 form, Your Honor.

. . . . . .

MR. TRANAKOS: It is a correction, Your Honor. It is to show the correct withholding and all that other data which should be on there to reflect the income that she had from working as a salaried employee as separated from her contract work that appears on Schedule C.

THE COURT: By what right do you prepare a W-2 form on behalf of the State of Maryland?

MR. TRANAKOS: Well, we weren't preparing it on behalf of the State of Maryland. We were preparing it primarily to show the Internal Revenue Service what would be the correct split between wages and contract.

We have a form from the State of Maryland that says that. That is already in evidence as well.

THE COURT: This purports to be a form prepared by the State of Maryland.

MR. WILES: It sure does.

MR. TRANAKOS: It's—well, it's not intended to reflect the State of Maryland prepared that form.

THE COURT: Mr. Tranakos, I view that with a great deal of seriousness.

fraud, but is a factor worthy of consideration, particularly when coupled with the submission of false withholding forms. *Hebrank v. Commissioner*, 81 T.C. 640, 642 (1983); *Habersham-Bey v. Commissioner*, 78 T.C. 304, 313 (1982).

The presence of fraudulent intent is clearly and convincingly established through numerous other facts of record, only a few of which need be mentioned herein.

Petitioners' refusal to cooperate with respondent in an effort to determine their correct liability, in the context of this record, is indicative of fraud. *Rowlee v. Commissioner*, 80 T.C. 1111, 1125 (1983). From the outset of the audit phase of this case, petitioners failed to produce for respondent's examination, books or records reflecting their income for the years in question. The evidence of record clearly suggests some destruction of income records after the audit began. We find petitioners' professed lack of any such records particularly curious in light of the fact that they managed to accumulate and retain innumerable receipts for items purchased, which petitioners alleged to be deductible. Petitioners also refused to firm up their contentions with respect to income and deduction items. Instead, they presented inconsistent and ever-changing positions in a transparent effort to delay progress in their case and to confuse respondent. We entertain no doubts but that petitioners' conduct towards respondent was an attempt to implement the teachings of their counsel, who has spoken on such subjects as "How to Trip Up the Government Agents."

Petitioners non-cooperation continued throughout the litigation phase of their case. Time and again they forced respondent to seek Court compulsion of discovery causing further delay in the resolution of their case. Petitioners' responses to Court orders bordered on contempt. On more than one occasion the Court advised petitioners and their counsel that it considered their conduct unacceptable or inexcusable. Petitioners largely ignored orders to turn over all relevant documents prior to trial, preferring instead to flood the Court in the course of the trial with innumerable pieces of paper which allegedly supported deductions. We found petitioners' explanations with respect to what those pieces of paper represented, as well as the bulk of their testimony in general, contradictory and highly incredible. The fact that petitioners failed to file a brief in this case, when they surely knew that

the Court could not possibly ferret out their final positions on issues without the aid of a brief, is a predictable course of conduct considering their obvious intent to frustrate the proper operation of the court system. In short, we cannot help but consider petitioners' conduct throughout the entire audit and trial of their case as indicative of an intent to conceal, mislead, or otherwise prevent the collection of taxes.

Finally, we note that the addition to tax in the case of fraud is a civil sanction provided primarily as a safeguard for the protection of the revenue and to reimburse the Government for the heavy expense of investigation and the loss resulting from the taxpayer's fraud. *Helvering v. Mitchell*, 303 U.S. 391, 401 (1938); *Rowlee v. Commissioner*, *supra* at 1123. In keeping with this purpose, the addition to tax for fraud for all of the years in question is clearly warranted.

Appropriate orders and decisions under Rule 155 will be entered.

Reviewed by the Court.

DAWSON, FAY, SIMPSON GOFFE, CHABOT, NIMS, PARKER, WHITAKER, KÖRNER, SHIELDS, HAMBLEN, COHEN, CLAPP, SWIFT, JACOBS, and WRIGHT,, *JJ.*, agree with this opinion.

WILBUR and GERBER, *JJ.*, did not participate in the consideration of this case.

JAMES K. CALCUTT AND JUNE B. CALCUTT, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

WILLIAM HERSHFELD AND PAMELA HERSHFELD, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 29849-83, 29850-83. Filed April 15, 1985.

During trial, petitioners attempted to establish their entitlement to losses from a subch. S corporation and depreciation allowable to the corporation. They did not file a post-trial brief in support of their contentions, notwithstanding Rule 151, Tax Court Rules of Practice and Procedure, an order setting dates

for seriatim briefs, and an order to show cause why the case should not be dismissed for their failure to do so. *Held*, issues are determined against petitioners because they failed to satisfy their burden of proof. *Stringer v. Commissioner*, 84 T.C. 693 (1985), distinguished.

James K. Calcutt and William Hershfeld, pro se.
John F. Dean, for the respondent.

COHEN, *Judge*: In docket No. 29849–83, respondent determined deficiencies in Federal income taxes of petitioners Calcutt in the amounts of $1,846 for 1980 and $7,430 for 1981. Respondent also determined an addition to tax in the amount of $371.50 under section 6653(a)[1] and that the full amount of that additional tax was subject to an increment of 50 percent of the interest due on the underpayment of $7,430 for that year.

In docket No. 29850–83, respondent determined deficiencies in the Federal income taxes of petitioners Hershfeld in the amounts of $716 for 1979, $1,975 for 1980, and $2,159 for 1981.

After concessions by each party, the issues for decision are (1) whether the basis of the respective petitioners in a subchapter S corporation may be increased to reflect a bank loan made directly to the corporation, and (2) the correct amount of depreciation on certain corporate assets.

FINDINGS OF FACT

Some of the facts have been stipulated, and the stipulations are incorporated herein by this reference.

All of the petitioners were residents of Maryland at the time their petitions herein were filed.

During the years in issue, petitioners were the shareholders of Uptown-Levy, Inc., a corporation that duly elected to be taxed under subchapter S of the Internal Revenue Code. Uptown-Levy, Inc., operated a delicatessen providing food service and liquor sales.

The delicatessen was operated on property located at 5402 and 5402½ Park Heights Avenue, Baltimore, Maryland. The property was acquired in December 1977, and the acquisition

[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years here in issue. All references to Rules are to the Tax Court Rules of Practice and Procedure.

was financed by a mortgage from Fairfax Savings & Loan Association, Inc. In relation to the financing and in addition to the mortgage on the corporate real estate, Fairfax Savings & Loan Association, Inc., demanded a lien on the personal residences of petitioners.

In the statutory notices of deficiency, among other adjustments no longer in issue, respondent disallowed losses of Uptown-Levy, Inc., as deductions to petitioners to the extent that petitioners had not substantiated that they had a basis in their respective shares of the corporation. Respondent also adjusted the amount of depreciation claimed by the corporation by reallocating among corporate assets the total cost of those assets and thereby reducing the cost basis of depreciable assets. Respondent's determination was based, in part, on an appraisal report dated October 25, 1977, that had been delivered to respondent's agents by petitioners' counsel during the course of the audit of petitioners' tax returns for the years in issue. The appraisal had been prepared in connection with the financing of the real estate acquisition by the corporation. The dispute as to the amount allocated to depreciable assets was narrowed, at the time of trial, to a dispute over the value of the corporation's liquor license.

The petitions herein were filed on behalf of petitioners by an attorney duly admitted to practice before the Tax Court. By notice setting case for trial served July 13, 1984, these cases were set for trial in Baltimore, Maryland, on October 1, 1984. On September 4, 1984, counsel for petitioners filed motions to withdraw appearance, citing ethical reasons why he was required to withdraw from these cases. The motions were granted. On the day of trial, Edward S. Margolis was present on behalf of petitioner William Hershfeld. At that time, however, Mr. Margolis was authorized to practice law but not admitted to practice before the U.S. Tax Court. He was therefore recognized specially on his representation that he would proceed to secure admission to the Tax Court, which he did. He did not, however, ever file a written entry of appearance in accordance with Rule 24(a)(3).

At the conclusion of trial, the Court ordered seriatim briefs, with petitioners' opening brief due December 3, 1984. No brief was ever received from petitioners. After a series of inquiries from the Court, Mr. Margolis advised the Court by letter that

petitioners did not intend to file a brief. Because Mr. Margolis had not entered his appearance on behalf of all of petitioners, the Court ordered petitioners to show cause on March 27, 1985, why these cases should not be dismissed under Rule 123(b) for failure of petitioners properly to prosecute or to comply with the Rules of the Court. Petitioners did not appear at the said hearing and did not file any written response to the Court's order.

OPINION

In this proceeding, petitioners have the burden of proving that respondent's determinations are incorrect and that petitioners are entitled to the deductions that they claim. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a).

During trial, petitioners presented evidence that they had given their personal residences as collateral for the loan to the corporation in order to enable the corporation to acquire the property from which it operated the delicatessen business. Petitioner James K. Calcutt also testified that, in his opinion, the liquor license had a value of $7,000 and that the value of $30,000, used in the appraisal done on behalf of the lender at the time of the loan and subsequently used in respondent's determination, was grossly overstated.

Respondent presented the testimony of the agent whose calculations formed the basis of the notice of deficiency. That agent testified that he received the appraisal report from petitioners' prior counsel during the course of his examination.

The respective parties each presented schedules during trial that showed how depreciation would be calculated in accordance with his contention or assumption as to the value of the liquor license. Neither party, however, presented independent evidence of the value of the license.

Petitioners did not file a trial memorandum, but, during trial, petitioner James K. Calcutt explained his contention that petitioners were entitled to include in the basis of their stock in the subchapter S corporation their proportionate shares of the loan made to the corporation. This contention was predicated solely on the argument that section 465, which is applicable to subchapter S corporations, includes in amounts considered "at risk" amounts borrowed for which the

taxpayer has pledged his interest in property unrelated to the activity to which the "at risk" rules are being applied. See section 465(b)(2)(B). The Court advised petitioners, however, that the at risk rules of section 465 deal only with certain at risk activities and have no bearing on this case, which deals with their basis in their corporate stock under subchapter S, i.e., sections 1371 et seq. Petitioners somehow believed, apparently, that section 465 engrafted additional meaning to the provisions of subchapter S, but it was by no means clear to the Court how they proposed to overcome the express language of those provisions and the case law contrary to their position.

During the years in issue, the pertinent provisions of subchapter S were set forth in section 1374(c)(2) as follows:

> (2) LIMITATION.—A shareholder's portion of the net operating loss of an electing small business corporation for any taxable year shall not exceed the sum of—
>
> (A) the adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of the shareholder's stock in the electing small business corporation, determined as of the close of the taxable year of the corporation (or, in respect of stock sold or otherwise disposed of during such taxable year, as of the day before the day of such sale or other disposition), and
>
> (B) the adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of any indebtedness of the corporation to the shareholder, determined as of the close of the taxable year of the corporation (or, if the shareholder is not a shareholder as of the close of such taxable year, as of the close of the last day in such taxable year on which the shareholder was a shareholder in the corporation).

Under these sections, corporate debts to third parties guaranteed by the shareholder, whether collateralized or not, do not lead to an increase in the shareholder's basis in his subchapter S corporation stock. See, e.g., *Blum v. Commissioner*, 59 T.C. 436 (1972).

On the depreciation issue, the uncorroborated opinion of petitioner Calcutt is insufficient to carry petitioners' burden of proof as to the value of the liquor license. He claimed that his opinion was based in part on a letter dated May 24, 1983, from a representative of the Board of Liquor License Commissioners for Baltimore City. That letter was not received in evidence because it was hearsay, and the author was not available for cross-examination. In any event, although it set forth a range of values for liquor licenses, it did not express any opinion as to

the specific license in issue in this case, which obviously would depend on factors such as the location of the facility, the volume of sales, and other facts not in evidence in this case. The unsupported opinion of petitioner Calcutt, therefore, need not be accepted. See *South Texas Rice Warehouse Co. v. Commissioner*, 366 F.2d 890, 897–898 (5th Cir. 1966), affg. 43 T.C. 540 (1965).

As of the end of the trial, therefore, petitioners had presented neither persuasive evidence nor legal ground for rejecting respondent's determination. They were, however, given an opportunity and a direction to file a brief under Rule 151. The purpose of the order to show cause hearing was to give petitioners a final opportunity to state their position based on review of the evidence produced at trial and the Court's comments during trial. This procedure further warned them of the possible consequences of their failure to file a brief.

This case is not, however, to be treated the same as *Stringer v. Commissioner*, 84 T.C. 693 (1985). That case involved a long and arduous history of noncompliance with our Rules by the taxpayers and their counsel. The record was eminently more complex, and the Court's job was made far too difficult by the taxpayer's failure to comply with the Rules and with the Court's direction to file a brief and specific instructions as to the contents of their brief.

We will give petitioners the benefit of the doubt in this case and assume that they merely abandoned their claims after they were advised by the Court at the end of trial that the positions that they had advanced up to that time lacked merit. Compare section 6673, which might be invoked if we were to conclude that the failure to file a brief was due to an intent to delay final resolution of the case.[2] As a courtesy to the Court and to respondent, they should have expressly conceded these

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[2] For cases commenced after Dec. 31, 1982, or if commenced prior thereto, pending as of Nov. 15, 1984, sec. 6673 provides:

SEC. 6673. DAMAGES ASSESSABLE FOR INSTITUTING PROCEEDINGS BEFORE THE TAX COURT PRIMARILY FOR DELAY, ETC.

Whenever it appears to the Tax Court that proceedings before it have been instituted or maintained by the taxpayer primarily for delay or that the taxpayer's position in such proceedings is frivolous or groundless, damages in an amount not in excess of $5,000 shall be awarded to the United States by the Tax Court in its decision. Damages so awarded shall be assessed at the same time as the deficiency and shall be paid upon notice and demand from the Secretary and shall be collected as a part of the tax.

issues if that was their intention. In any event, under these circumstances we do not dismiss the case merely by reason of petitioners' failure to comply with the Rules and the order for briefs.

We do, however, decide the disputed issues against petitioners by reason of their failure to satisfy their burden of proof. Because of concessions,

Decisions will be entered under Rule 155.

ROBERT C. CHIU AND CAROL A. CHIU, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 14166–83. Filed April 15, 1985.

Petitioners purchased gemstones and minerals in the years 1977, 1978, and 1979, and approximately 1 year after the dates of purchase donated them to the Smithsonian Institution. *Held*, the most reliable evidence of the fair market value of the items was the cost of the items to the petitioners.

Ronald W. Gabriel and *Charles M. Steines*, for the petitioners.

Nancy Herbert and *Robert J. Kastl*, for the respondent.

COHEN, *Judge*: Respondent determined deficiencies in petitioners' Federal income taxes as follows:

Year	*Deficiency*
1978	$20,508.17
1979	46,429.93
1980	36,550.00

In dispute is the value of certain gemstones and mineral specimens donated by petitioners to the Smithsonian Institution.

FINDINGS OF FACT

Some of the facts have been stipulated, and the stipulation is incorporated herein by this reference. Petitioners were residents of Columbus, Ohio, at the time they filed their petition

herein. They filed joint Federal income tax returns for the taxable years 1978, 1979, and 1980 with the Cincinnati Service Center, Covington, Kentucky.

Items in Dispute

On or about October 3, 1977, petitioners acquired a group of 10 gemstones from Pala Properties International, Inc. (Pala), of Fallbrook, California, at a cost of $11,000. This group included one 36.40-carat sinhalite acquired at a cost of $2,912. On or about October 15, 1977, petitioners acquired one 75-carat cat's-eye rubellite tourmaline from Gemarvi Pedras Preciosas Ltd., Governador (Gemarvi) of Valaderes, Brazil, at a cost of $7,500. On or about December 21, 1978, petitioners donated the sinhalite and the tourmaline to the Smithsonian Institution (the Smithsonian). On their tax return for 1978, petitioners claimed a deduction of $15,470 for contribution of the sinhalite and $35,625 for contribution of the tourmaline.

On or about April 22, 1978, petitioners acquired from Charles Key of Sarasota, Florida, a 239-carat topaz at a cost of $5,975. On or about July 30, 1978, they acquired from Gemarvi one 7.66-carat euclase at a cost of $3,500. On or about August 24, 1979, they donated to the Smithsonian the topaz, the euclase, the nine other gemstones acquired from Pala in October 1977 at a total cost of $8,088, and one 7.10-carat cerussite, the seller, date of acquisition, and cost of which are unknown.

On or about November 19, 1978, petitioners acquired from Charles Key one 373.29-carat lithium niobate for $4,479. On or about December 27, 1979, they donated the lithium niobate to the Smithsonian.

On their tax return for 1979, petitioners claimed charitable deductions of $35,850 for the topaz, $19,150 for the euclase, $39,619 for the group of nine gemstones, $532 for the cerussite, and $24,263.85 for the lithium niobate.

On or about July 11, 1979, petitioners acquired one 18.29 carat euclase from International Lapidaries of Boynton Beach, Florida, at a cost of $15,000. On or about August 4, 1979, petitioners acquired 27 mineral specimens from Mineral Kingdom of Woodmere, Long Island, New York, at a cost of $5,000. On or about November 5, 1980, petitioners donated the euclase and the 27 mineral specimens to the Smithsonian. On

their tax return for 1980, petitioners claimed a deduction of $64,015 for the euclase and $28,775 for the 27 mineral specimens.

In the statutory notice of deficiency, respondent disallowed petitioners' claimed deductions in excess of $10,750 for 1978, $26,555 for 1979, and $20,000 for 1980.

Petitioners never purchased any insurance with respect to any of the gemstones or mineral specimens contributed by them to the Smithsonian in 1978, 1979, or 1980. They had never sold any gemstones or minerals. Petitioner Robert C. Chiu is by occupation a physician, and petitioners have no demonstrated experience in dealing in gems or minerals.

The prices for gemstones and mineral specimens remained stable during the years in issue, and there was no significant appreciation in value of the items donated by petitioners to the Smithsonian between the times of acquisition and the times of donation.

Although some of the smaller items in issue potentially could be sold to jewelers to be set in jewelry, the most likely ultimate consumer for most of the items was an individual collector or a museum.

The amounts claimed by petitioners on their tax returns were based on appraisals obtained by petitioners. Most of the appraisals were obtained from William W. Pinch (Pinch) at or about the time that the items were acquired. On or about May 15, 1984, in preparation for trial of this case, Pinch reappraised most of the items that had been contributed to the Smithsonian by petitioners during the years in issue. The reappraisal was requested to take account of the Court's opinion in *Anselmo v. Commissioner*, 80 T.C. 872 (1983). Set forth in the Appendix is a chart showing the amounts determined by Pinch's reappraisal and the values attributed by other experts testifying at trial, as set forth below.

William W. Pinch

Pinch is a collector of mineral specimens and the owner and curator of the Pinch Mineralogical Museum, which contains approximately 16,000 mineral specimens. He has been engaged in the field since 1947 and is sufficiently knowledgeable to be regarded as an expert in mineralogy. He is not, however, formally trained in gemology or appraisal techniques.

From 1979 through the time of trial, Pinch was employed by Investment Rarities to buy gemstones and train employees who would be selling gemstones over the telephone. Investment Rarities sold gemstones to the public for a standard markup of 25 percent.

Pinch's reports comprising his May 1984 appraisals were prepared by petitioners' counsel from the appraisal reports attached to petitioners' tax returns. Language drafted by counsel and defining fair market value was added. Pinch nonetheless signed the appraisals. In several instances his testimony at trial in July 1984 differed from certificates of appraisal signed by him and dated May 15, 1984. For example, his 1979 appraisal of the 3.00 carat jeremejevite (acquired as a part of the nine gemstones purchased in October 1977 at a cost of $8,088) described the item as "probably the world record," and valued it at $6,000. His May 1984 report repeated that statement and value, although, according to Pinch, "that shouldn't be on there. It is not the world record." A similar incident occurred with respect to the 18.29 carat euclase acquired in July 1979. Another item was appraised as an "exceedingly large" epidote. Although Pinch was advised prior to trial that this item was not an epidote, he did not change his report prior to testifying that "this is obviously an error on my part * * * the stone is a tourmaline, either a uvite or a dravite. I have not examined it since [1979]." Other items described by Pinch as without flaws or "clean" were shown to have visible inclusions. His appraisal reports were replete with superlatives such as "exceedingly" large or rare, "superb" and "flawless," that were not justified upon an item-by-item examination by the various experts at trial.

Pinch's appraisals for the most part were not based on any actual sales of comparable items. In many instances, he relied on reported offering prices without verifying whether those prices had ever in fact been paid for such items. Some of his valuations were based on information from William Larson, the owner of Pala. His appraisals did not take into account the cost of the items appraised, even those acquired from Pala at about the same time as his original appraisal. In valuing the 75.00 carat cat's-eye rubellite tourmaline acquired in October 1977, Pinch ignored the purchase price of $7,500. His appraisal report valued the stone as of December 1978 at $28,125 while

stating: "It is a bit difficult to place a value on a gem when there are no records of similar size and quality stones ever being sold." Although his reports identified alternative ultimate consumers for the items appraised, he did not determine alternative values.

Paul Desautels

Paul Desautels (Desautels) was curator of the Gem and Minerals Collection at the Smithsonian for 25 years, including the time that the items in issue here were donated. He left the Smithsonian in 1982. At the time of trial, he was employed as a consultant to an individual collector of mineral specimens. He is knowledgeable and qualified as an expert in gems and minerals. He received no formal training, however, in gemology or in appraisal of gemstones or mineral specimens, and he does not have extensive experience in the purchase or sale of gems or minerals.

Desautels did not generally place values on items at the time they were donated to the Smithsonian. Although he expressed an opinion of the value of some mineral specimens in issue at the time of trial of this case, many of those specimens were not in the same condition as they had been at the time of the donation because they had been damaged after the time of donation. His valuation at the time of trial was therefore based on his recollection of the condition of the items from 2 to 5 years earlier. Desautels had no explanation for the damage to the mineral specimens that took place after the donation to the Smithsonian because valuable items were set apart in a special room to be handled only by special persons.

Desautels' estimates of the values of the items donated to the Smithsonian were based on his observation of the range of offering prices for specimens and his opinion of the relative quality of the particular specimen. The range of prices for some varieties was as great as from $30 to $200 a carat for blue topaz; $100 to $10,000 for wulfenite crystals; $100 to $7,000 for anglesite crystals; and $100 to "several thousands" dollars for cerussite crystals. He described the prices as "all over the map" and the market for collector items as "chaotic * * * completely chaotic." He could not state a value for the sinhalite contributed to the Smithsonian by petitioners in 1978 because:

There's no way to establish a price structure. There are no stones of considerable size. There's no way to establish that kind of market.

The price in this case as in most cases of very exotic gemstones is what the market will bear. That means, the dealer has to know, has to have a stable of customers, has to know what they'll stand for. And as he normally does, he leans hard, gets one competing against the other and gets the highest price he can get.

His opinion that the leadhillite specimen donated to the Smithsonian by petitioners in 1980 had a value of $1,000 was qualified as follows:

Each specimen is unique. Every mineral specimen is unique. And a matter of judging—it's a true free market what the seller will let it go for, and what the buyer will pay for it. And the only way that you can establish what the market is is what the availability of the material is, how will you go for it, and that's the price.

Desautels could not recount specific sales transactions in the items he valued because:

Business in exotic gems, really fine top quality exotic gems and in fine mineral specimens is a very secretive business. Dealers don't tell you and there's no way to know—you can't ever see invoices and you can't see money change hands. It's done—you know they're sold because you know where they were and you know where they went.

In purchasing gemstones, Desautels had never been able to get a discount greater than 30 percent from the asking price, even at a time when the dealer was under pressure to sell. The normal discount by a dealer under pressure is 10 percent from the asking price.

Among the five persons considered by Desautels to be among the most "prominent" in the field of gemstones were William Larson of Pala and Pinch. Desautels had a longstanding relationship with Pinch, for whom he wrote letters of recommendation in 1981 and 1982.[1]

Cosmo Altobelli

Cosmo Altobelli (Altobelli), one of respondent's experts, is a jeweler and appraiser. He has been in the business of appraising since 1948. Also beginning in 1948, Altobelli became

[1] The letters themselves were not received in evidence. The testimony that Desautels wrote such letters for Pinch was not objected to and may be considered.

involved in mineral specimens and compiled a personal collection in excess of 100 specimens. He has been a Graduate Gemologist since 1969, having completed a 6-month residency course consisting of classes given 5 days a week for 8 hours each day by the Gemological Institute of America (GIA). The course included training in the use of full instrumentation and instruction on gemstones generally encountered in the jewelry industry, as well as stones typically found in museums or acquired by collectors. In 1970, Altobelli received a degree as a Certified Gemologist, which requires the title of Graduate Gemologist and an additional course in retailing. He is also a Certified Gemologist Appraiser, a title conferred by the American Gem Society upon completion of an examination. Altobelli developed an examination used by the American Gem Society for certification of Certified Gemologist Appraisers. He authored a book on jewelry appraisal guidelines and is a member of various professional organizations and of the Appraisal and Ethics Committee of the American Gem Trade Association. At the time of trial, Altobelli had been retained by GIA to appraise its entire collection of over 15,000 pieces of gemstones, cut stones, mineral specimens, organic materials, carvings, and rough materials. He is experienced in the purchase and sale of mineral specimens. He did not independently test the items at issue herein to determine their identity before preparing his report as to their value.

Elly Rosen

Elly Rosen (Rosen), respondent's other expert, is a gemological appraisal consultant and a Graduate Gemologist of GIA. The latter title was earned by completion of proficiency examinations and a 2-year course of instruction on diamonds, colored stones, and gem identification. He is a senior member of the American Society of Appraisers, certified in gems and jewelry upon completion of an examination on appraisal ethics, appraisal theory, and gems and jewelry. He teaches courses in the appraisal of gems and jewelry, including appraisal ethics, research techniques, identification and authentication procedures, terminology, and report writing. He is a member of various other professional societies. During the years in issue, he performed in excess of 100 appraisals encompassing approximately 1,000 items.

ULTIMATE FINDINGS OF FACT

Each of the experts testifying on behalf of the parties was experienced in identifying and categorizing the items about which he testified and had some experience qualifying him to testify in the form of an opinion as to the value of those items. Because of the sporadic nature of the gem and mineral markets and the uniqueness of many of the items in question, however, their opinions as to the value of most items were based on very little, if any, information of actual sales of comparable items.

Petitioners' experts, Pinch and Desautels, had little experience and essentially no training in appraisal techniques. Pinch's opinions as to value were based upon superficial examination of the items on which he expressed an opinion, contained numerous errors, and did not accurately reflect fair market value. Desautels' opinions did not accurately reflect fair market value.

Respondent's experts, Altobelli and Rosen, performed careful and systematic examinations of the items, using recognizable standards of appraisal attributable to their training and background. Their experience in dealing with collectibles, however, was limited; and they necessarily relied on researching reported transactions rather than on personal knowledge.

The value of the items donated by petitioners to the Smithsonian Institution in 1978, 1979, and 1980 was the same as the cost of those items acquired by petitioners in 1977, 1978, and 1979. There is no reason to believe that petitioners received a discount from the price that would have been paid by the ultimate consumer of the items in transactions between a willing and knowledgeable buyer and a willing and knowledgeable seller, neither being under compulsion to buy or sell.

The value of the 7.10 carat cerussite, the cost and date of acquisition of which is unknown, was $284 on the date of donation, August 24, 1979. (As appears from the Appendix, this amount is the value determined by Altobelli.)

OPINION

There is no dispute in this case that an actual donation was made to a qualified charitable donee under section 170(c).[2] To determine the allowable deduction, however, we must determine the fair market value of the donated property, to wit, "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Section 1.170A–1(c)(2), Income Tax Regs. The parties differ—and as shown in the Appendix, the differences are great—as to the value of the items donated.

The testimony of Pinch, of course, might not be expected to be free of bias because he had provided most of the appraisals on which the deductions in issue in this case were based. The editing of his reports by counsel and numerous uncorrected errors, as described in the findings of fact, cast serious doubt on the reliability of his opinions. We conclude that this is a case where "Petitioners' expert witness so exaggerated his estimates of the value of * * * [the property] that his testimony was incredible, i.e., not credible." *Dean v. Commissioner*, 83 T.C. 56, 75 (1984); *Fuchs v. Commissioner*, 83 T.C. 79, 99 (1984).

It would be hard to deny that Desautels is, by experience, an expert in identifying and categorizing gems and minerals and qualified to give an opinion as to the relative quality and rarity of particular specimens. His background and experience in appraising items, however, is not so impressive. He testified that only a small number of the items in the Smithsonian gem and mineral collection were acquired by purchase and that much of the gem and mineral industry depended on physical trading of gems. His general testimony as to the basis of his opinions, set forth in the findings of fact, would support the conclusion that any opinion is far too subjective to be reliable evidence of the value of a particular item without regard to an actual sale of that item. Desautels described the gem and mineral markets as "chaotic." He described prices in terms of "whatever the seller can get." In determining his own opinion of the value of any item, he disregarded any appraisals by any other persons. He specifically did not take into account the

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[2] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

cost of the items to petitioners or the appraisals by Pinch of the items donated to the Smithsonian in this case. Desautels' criteria cannot be equated with the recognized and applicable definition of fair market value.

We find it particularly astonishing that neither Desautels nor Pinch took into account the prior sales of the same items to petitioners, even though the seller of some items, Larson of Pala, was identified by each of them (and by Altobelli) as a person on whom they relied in reaching their opinions. There is no credible explanation of how petitioners, with no demonstrated training or experience, were able to acquire numerous items at 75 to 90 percent discounts from value when Desautels could at most obtain a discount of 30 percent from a seller under pressure, and the usual discount was 10 percent. Pinch was involved in selling gemstones over the telephone at markups of only 25 percent.[3] The evidence negated any inference that market conditions would explain an increase in value between the date of purchase and the date of donation. Petitioners did not testify, and, from their failure to do so, we infer that their testimony would not have been helpful to them.[4] See *Wichita Terminal Elevator Co. v. Commissioner*, 6 T.C. 1158, 1165 (1946), affd. 162 F.2d 513 (10th Cir. 1947).

Petitioners' counsel sought unsuccessfully to elicit an explanation from Pinch as follows:

Q. First of all, let me ask you one preparatory question. Do you think that appreciation in a one-year period of time is the basis for the increase in value or the difference in value between what was paid and what you appraised any stone at?

A. No, things don't just increase in value like that generally.

Q. The prices have been fairly stable for all the items we have been discussing.

A. You know, they're fairly stable within a certain percentage, 20 percent.

Q. All right. Would you go ahead and explain to the Court based on your experience in dealing—not dealing but trading and buying stones and exchanging stones and your conversations with others in the field, why do you think this could have occurred or did occur?

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[3] In the related case of *Talebi v. Commissioner*, T.C. Memo. 1985-180, in which the parties stipulated that the qualifications portion of Pinch's testimony in this case would be incorporated, Pinch testified that the maximum discount obtainable for gemstones would be 50 percent.

[4] This case was originally set for trial May 7, 1984, in Columbus, Ohio, but was continued at the request of petitioners because of the unavailability of Pinch. The place of trial was changed to Washington, D.C., but petitioners were given the opportunity to testify in Columbus, Ohio.

A. It's quite possible at any gem and mineral show if you know what you're doing to walk in and buy something at one side of the show and in some cases, go over to the other side of the show and turn around and sell it for three to five times, sometimes even 10 times as much as you paid for it.

* * * * * * *

A. There are cases where dealers are selling things that they do not know what they are. * * *

* * * * * * *

A. There are some cases when dealers may even know what they have there, and they just aren't quite aware of what the top dollar they could get for the material is.

There are cases where they've had material faceted from rough, and they're concerned only about the cost that they have in it. And they haven't researched the market. There are rare gems occasionally that get sold for way less than they should be sold for.

I think most anyone that's been into the collectibles market know this can happen with antiques or it can happen with a lot of things.

* * * * * * *

A. Yes, I don't think, in many of these cases, that the stones increased at all. I think that that was the value, the dollar's value on the stones probably when they were bought.

I don't know the exact date that they were bought or the exact price that was paid. In the minerals I know what was paid.

Q. One final point, Mr. Pinch. I'm sure it's crossed everybody's mind in this case that it's—must be extreme good fortune on the part of the Doctor to pick up so many different gemstones and mineral specimens, and for whatever reason acquire stones at 25 percent of their value as appraised by you. Could you shed any light on that at all?

MS. HERBERT: Your Honor, I object. It has not been shown that this witness has personal knowledge of Dr. Chiu's purchases or that he was present at the time of purchase or knows where the items were, in fact, purchased.

THE COURT: The objection is sustained.

BY MR. STEINES:

Q. Mr. Pinch, are you familiar with the circumstances in which Dr. Chiu acquired his stones?

A. Which—

Q. Gemstones—excuse me, his mineral specimens?

A. Yes, the mineral specimens.

Q. Were you present when that occurred?

A. Yes.

Q. Did you offer any advice to him?

A. He came to me for advice. He had selected—he had a group of things selected, and he came to me to ask me about the value of the material that he had selected.

And he asked me to talk to the person that was selling them and see if I could get some more things thrown in and argue—help him argue the price, which I did.

Q. And at the time that Dr. Chiu had selected his initial groupings of stones, had he done a pretty good job, in your opinion, of obtaining choice specimens for a—what you would consider to be a very good price?

A. I thought it was a very nice selection.

The speculation as to why one might occasionally buy an item at less than "top dollar" is strikingly unrelated to what actually happened in this case and, in any event, is not relevant to determination of *fair market value*. Notwithstanding the insertion of definitions of fair market value into Pinch's reports by petitioners' counsel, we have serious doubts as to Pinch's understanding of or conformity to that standard.

Both Pinch and Desautels testified that the difference between the opinions of petitioners' experts and the opinions of respondent's experts was the failure of respondent's experts to recognize that the collector market depended more on the rarity and world-record size of particular items than on specific qualities of the specimens. Once Pinch's errors were corrected, there was little difference between the experts' opinions as to the specific qualities of the items in issue; but they differed as to the significance of those qualities. Petitioners' experts did not dispute the qualifications of respondent's experts as gemologists or the care with which respondent's experts approached their task.

Petitioners attempted to impeach the opinion of respondent's expert Altobelli by asking him to identify, without any preparation, instruments, or research material, certain mineral specimens. Those specimens were from the collection of Pinch and were not among the items that Altobelli had previously been asked to examine. Altobelli was unable to identify accurately one of the specimens. We were not impressed by this exercise, however, because Altobelli's opinion as to the items in issue assumed that the items had been correctly described by the Smithsonian. Pinch, by contrast, made a mistake in identifying a gemstone that he had specifically appraised twice, because, by his own admission, he failed to carefully examine the item even after a possible

mislabeling had been called to his attention by personnel of the Smithsonian.

Nonetheless, we conclude that there is merit to petitioners' attempt to distinguish between appraisal of gemstones for use in jewelry and valuation of specimens for collector purposes. Although Altobelli and Rosen expressed opinions of the value of items in the collector market, their experience in dealing with collectibles was limited. That does not mean, however, that we must accept the opinions of petitioners' experts when those opinions cannot be tested against adequate evidence of comparable sales or other objective standards and, for the reasons stated above, are not persuasive.

Although opinion evidence is obviously admissible and relevant on the question of value, we must weigh such evidence in light of the demonstrated qualifications of the expert and all other evidence of value. *Anderson v. Commissioner*, 250 F.2d 242, 249 (5th Cir. 1957), affg. a Memorandum Opinion of this Court. We are not bound by the opinion of any expert witness when that opinion is contrary to our own judgment. *Barry v. United States*, 501 F.2d 578 (6th Cir. 1974); *Kreis' Estate v. Commissioner*, 227 F.2d 753, 755 (6th Cir. 1955); *Tripp v. Commissioner*, 337 F.2d 432 (7th Cir. 1964), affg. a Memorandum Opinion of this Court. We may embrace or reject expert testimony, whichever, in our best judgment, is appropriate. *Helvering v. National Grocery Co.*, 304 U.S. 282 (1938); *Silverman v. Commissioner*, 538 F.2d 927, 933 (2d Cir. 1976), affg. a Memorandum Opinion of this Court.

Because of the excess of advocacy, or "overzealous effort" of petitioners' experts here, we might merely adopt the opinion of respondent's more reasonable expert. See *Buffalo Tool & Die Mfg. Co. v. Commissioner*, 74 T.C. 441, 451–452 (1980). Or we might merely conclude that petitioners have failed to satisfy their burden of proof. See *Anselmo v. Commissioner*, 80 T.C. 872, 885–886 (1983). In this case, however, we have what has been described as the most reliable evidence of value, to wit, sales of the same property within a short period of time prior to the valuation date. In another context, the Court of Appeals for the Sixth Circuit, the court to which our decision in this case is appealable, has recently stated that "In determining the fair market value of property, little evidence could be more probative than the direct sale of the property in

question." *Estate of Kaplin v. Commissioner*, 748 F.2d 1109, 1111 (6th Cir. 1984), revg. a Memorandum Opinion of this Court. In a case involving facts similar to those before us here, but where respondent did not produce expert testimony contradicting that of petitioners, the Court of Appeals in *Tripp v. Commissioner, supra*, explained:

> The petitioner contends that inasmuch as the respondent offered no expert testimony the testimony of petitioner's expert witnesses should have been heeded and their opinions accepted by the Tax Court as determinative of the December 1955 value of the jewelry and that it was clearly erroneous for that court to reject their valuations. But the record discloses that the opinion testimony of these witnesses was almost wholly subjective in character. And, opinion evidence which does not appear to be based upon disclosed facts is of little or no value. Balaban & Katz Corp. v. Commissioner, 7 Cir., 30 F.2d 807, 808. Petitioner's witnesses failed to support their conclusions as to value with facts of convincing probative value. The Tax Court was not, under the circumstances, obliged to accept as sound the opinion of the taxpayer's experts. Helvering v. National Grocery Co., 304 U.S. 282, 295, 58 S.Ct. 932, 82 L.Ed. 1346; Dayton P. & L. Co. v. Public Utilities Commission, 292 U.S. 290, 299, 54 S.Ct. 647, 78 L.Ed. 1267. In the absence of any convincing reason forming a basis for the opinions expressed we are of the view that the Tax Court was fully justified in concluding that the cost of the jewelry to the petitioner in 1953 was the best evidence of its fair market value in December of 1955, the date of the gift. Cost, here, was cogent evidence of value. Cf. Guggenheim v. Rasquin, 312 U.S. 254, 258, 61 S.Ct. 507, 85 L.Ed. 813; Gessell v. Commissioner, 7 Cir., 41 F.2d 20, 22. There is no substantial evidence that any situation arose or development occurred in the interim which increased the value of the collection. * * *
>
> In view of the unsatisfactory nature of the expert opinion testimony and its lack of a realistic basis in fact we see no ground for upsetting the fair market value finding of the Tax Court as clearly erroneous. It is based on facts definitely established—the price a collector of such objects paid a dealer-expert on the advice of another expert who was anxious that the purchaser make the acquisition; and the valuation used for insurance purposes during the pre-gift period.
>
> [*Tripp v. Commissioner*, 337 F.2d at 434–435.][5]

Although petitioners did make a bulk purchase of some of the gems and mineral specimens in question here, and the donated items must be valued on an individual basis (*Anselmo*

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[5] In our Memorandum Opinion, we stated:

"Where sales of property to be valued have been made at or about a crucial date, they are preferred as evidence of value rather than opinion. *Andrews v. Commissioner*, 38 F.2d 55 (C.A. 2, 1930), affirming 13 B.T.A. 651 (1928); *John J. Flynn*, 35 B.T.A. 1064 (1937). [*Tripp v. Commissioner*, T.C. Memo. 1963–244, 22 T.C.M. 1225, at 1231, 32 P-H Memo T.C. par. 63,244, at 63–1398.]"

v. Commissioner, 80 T.C. at 883–884), the individual values attributed by the more credible experts do not in total vary significantly from the bulk price paid.

There is no credible evidence that petitioners' acquisitions were at prices not reflecting the appropriate market, and, in any event, petitioners' experts did not vary their opinions based on alternative markets. On the basis of the entire record, we conclude that the fair market value of the donated property on the date of donation was the cost of the property to petitioners.

In concluding that the cost of the property is the best evidence of fair market value, we are, of course, also considering the other evidence in the record and the absence of evidence that would otherwise be relevant. Although petitioners did not testify, their failure to take steps to secure, insure, or prevent damage to the property is in evidence. Although no current employee of the Smithsonian testified, evidence in the record suggests that the donee did not take steps to secure, protect from damage, display, or otherwise make use of the property. The use to which donated property is put (or, by implication, the failure to put property into use) is relevant. See *Skripak v. Commissioner*, 84 T.C. 285, 322–323 (1985); *Cupler v. Commissioner*, 64 T.C. 946, 955 (1975).[6] These factors reinforce our rejection of the inflated values claimed by petitioners.

Because the amounts allowed in the notice of deficiency were not less than cost, and respondent has not sought an increased deficiency

Decision will be entered for the respondent.

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[6] In *Skripak v. Commissioner*, 84 T.C. 285 (1985), the Court found that the fair market value of the donated property was approximately 60 percent of what petitioners had paid slightly more than 6 months before. Because, in this case, respondent's experts testified that the fair market value of some items was less than petitioners' cost, such a finding would not be out of the question here, if we were inclined to rely on the expert testimony. See *Price v. Commissioner*, T.C. Memo. 1985–182.

APPENDIX

DONATIONS ON OR ABOUT DEC. 24, 1978

		Experts' Values[1] as of Donation Date		
	Item	*E. Rosen*	*C. Altobelli*	*W. Pinch*
1.	One tourmaline, 75 carats	$3,001.20	$7,500.00 (5,252.10)	$28,125
2.	One sinhalite, 36.40 carats	2,914.40	4,500.00	12,740
	Totals	5,915.60	12,000.00 9,752.10	40,865

DONATIONS ON OR ABOUT AUG. 24, 1979

1.	One euclase, 7.66 carats	$3,264.00	$2,298	$15,320
2.	One rhodochrosite, 21.32 carats	3,198.00	1,279	4,264
3.	One elbaite variety rubellite, 37.83 carats	2,649.50 (5,034.05)	5,675	9,457
4.	One jeremejevite, 3 carats	450.00	750	6,000
5.	One cassiterite, 12.6 carats	631.50	1,260	2,520
6.	One apophyllite, 9.27 carats	278.10	278	927
7.	One apatite, 30.98 carats	930.30	1,239	3,098
8.	One sphene, 27.76 carats	416.55	694	2,766
9.	One chrome kornerupine, 1.02 carats	130.00	127	510
10.	One 10.7 carat stone "epidote tourmaline"	107.00	428 (Approx. $214)	2,140
11.	One cerussite, 7.10 carats	106.50	284	355
12.	One topaz, 239 carats	3,728.40 (5,736.00)	5,975	23,900
13.	One lithium niobate, 373.29 carats	4,200.00	5,600	13,065
	Totals	20,089.85 (24,482.00)	25,673	84,322

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DONATIONS ON OR ABOUT NOV. 5, 1980

Gemstone				
1.	One euclase, 18.29 carats	$10,980	$5,487	$36,580
	Subtotal	10,980	5,487	36,580
Mineral specimens				
2.	One leadhillite		125	[3]500
3.	One malachite on calcite		100	200
4.	One smithsonite (pale yellow)		100	350
5.	One mimetite on dolomite		50	75
6.	One cuprian dolomite with pyrolusite		100	150
7.	One wulfenite		70	100
8.	One copper on calcite		65	75
9.	One willemite on smithsonite		50	100
10.	One cerussite with copper inclusions		75	100
11.	One anglesite (yellow)		85	175
12.	One azurite		Stone not available	2,000
13.	One wulfenite (blue) on matrix		100	100
14.	One smithsonite on tenantite		150	450
15.	One dioptase		350 (400)	2,500
16.	One willemite (blue)		100	300
17.	One rhodochrosite		400 (450)	2,500
18.	One smithsonite (yellow)		200	750
19.	One smithsonite (pink)		250	2,000
20.	One smithsonite (hugh group)		400 (500)	2,000
21.	One malachite psuedomorph after azurite		500	2,000

APPENDIX

22.	One mimetite on cerussite on mottramite		$500	$1,750
23.	One wulfenite		125	500
24.	One anglesite		300	3,500
25.	One calcite		400	1,000
26.	One cuprite with copper and malachite after calcite		200	600
27.	One cerussite		300	3,000
28.	One smithsonite		125	175
			5,220	
	Subtotal—mineral specimens	N/A	(5,420)	26,950
	Subtotal—gem specimens	$10,980	15,487	36,580
			10,707	
	Total for 1980	10,980	(10,907)	63,530

[1]Secondary or alternate values given by experts, whether due to alternate market or claimed damage, indicated in parentheses.

[2]Desautels testified that in his opinion the value was $1,000. Otherwise the opinions stated by Desautels approximated those of Pinch.

PIGGLY WIGGLY SOUTHERN, INC., SOUTHERN GRAPHIC ART, AND GEORGIA SALES COMPANY, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 18886–82. Filed April 18, 1985.

P purchased equipment for use in its remodeled, new, and relocated supermarkets. The equipment installed in the remodeled stores was in use in the fiscal years of purchase. The remodeled stores were not officially opened until subsequent fiscal years. The new and relocated stores did not open for business until the fiscal years subsequent to the fiscal years in which the equipment was purchased. *Held*, only the equipment installed in the remodeled stores was "placed in service" in the fiscal years of purchase and qualified for depreciation and investment tax credits pursuant to secs. 167 and 38, I.R.C. 1954.

P installed HVAC units in several of its supermarkets in 1977 and 1979. Because the sole justification for the installation of the HVAC units was the necessity of meeting the temperature and humidity requirements of the refrigeration equipment in

P's stores, the HVAC units were not structural components. The HVAC units were not portable air-conditioning and heating units. *Held*, because the parenthetical language added in 1978 to sec. 48(a)(1)(A), I.R.C. 1954, excluded only portable air-conditioning and heating units from the definition of tangible personal property, the HVAC units installed by P in both 1977 and 1979 constituted tangible personal property and qualified as "sec. 38 property" for investment tax credit purposes.

Charles T. Zink, for the petitioners.
J. Steven Erie, for the respondent.

HAMBLEN, *Judge*: Respondent determined the following deficiencies in petitioners' Federal corporate income taxes:

Fiscal year	*Deficiency*
June 25, 1977	$82,057.00
June 24, 1979	1,271.56

After concessions, the issues for decision are: (1) Whether new equipment purchased by petitioner Piggly Wiggly Southern, Inc. (Piggly Wiggly),[1] during the fiscal years 1977 and 1979 for use in its new, relocated, or remodeled stores was "placed in service" during those fiscal years and therefore qualified for depreciation and investment tax credits under sections 167[2] and 38 during the years at issue; and, (2) whether central heating and air-conditioning units installed by petitioner in its stores qualified as section 38 property for investment tax credit purposes.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Piggly Wiggly, a Georgia corporation, filed timely corporate returns on the accrual basis for the fiscal years 1977 and 1979. During these years, petitioner was engaged in the retail

[1] Southern Graphic Art and Georgia Sales Co. are wholly owned subsidiaries of Piggly Wiggly. They are parties to this action only by virtue of having filed consolidated corporate returns with Piggly Wiggly. Therefore, "petitioner" in the singular form hereinafter refers to petitioner Piggly Wiggly.

[2] All section references are to the Internal Revenue Code of 1954 as amended and in effect for the taxable years at issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

marketing of food products and operated a chain of supermarket stores throughout Georgia.

During its fiscal years ending June 25, 1977, June 24, 1978, and June 24, 1979, petitioner purchased new equipment for use in the operation of new, relocated, and remodeled stores. It deducted depreciation allowances and claimed investment tax credits for the fiscal years in which the equipment was purchased. The new equipment consisted of items such as refrigerated display cases, shopping carts, mixers, saws, and scales.

Alton Holloway (Holloway) was petitioner's vice president in charge of research and store development during the years in issue. His duties included determining when a new store was needed, monitoring the installation of equipment, and approving payment invoices for newly purchased machinery and equipment. Holloway did not approve payment invoices until the machinery and new equipment were received and installed.

During 1977 and 1978, petitioner remodeled four stores. The stores were not closed during the remodeling period. When remodeling was completed, the stores closed for 1 day to clean up, replace signs, and change prices for promotional activity. Some of the new equipment purchased during the fiscal years 1977 and 1978 was installed in these stores. New equipment was operational and in use at the remodeled stores on the day of installation. Petitioner claimed depreciation deductions and investment tax credits for the fiscal years in which the equipment was installed.

In 1977, 1978, and 1979, petitioner opened five new and one relocated stores.[3] Petitioner's new and relocated stores required the construction of new store buildings. Some of the new equipment purchased during the fiscal years 1977, 1978, and 1979, was placed in these stores. These six stores did not open for business until after the close of the fiscal years in which depreciation deductions and investment tax credits were claimed on the new equipment.

Set forth below is a summary outlining (1) the date petitioner opened the new, relocated, and remodeled stores; (2) the fiscal year in which petitioner claimed deductions and credits

[3]The stipulation of facts includes a sixth new store, Warner Robins 35. However, this store is not listed in the statutory notice as one for which the deductions are in issue.

on equipment; and, (3) the fiscal year in which respondent determined the deductions were proper:

Store	*Date opened*	*Fiscal year claimed*	*Fiscal year statutory notice*
New Macon 81	July 20, 1977	1977	1978
Remodeled Statesboro 28	Sept. 20, 1977	1977	1978
Relocated Wrightsville 52	Feb. 8, 1978	1977	1978
New Augusta 77	Oct. 26, 1977	1977	1978
New Cordele 38	Feb. 8, 1977	1978	1979
New Sylvester 70	Nov. 17, 1979	1978	1980
Remodeled Moultrie 66	Oct. 1, 1978	1978	1979
Remodeled Dublin 43	Nov. 8, 1978	1978	1979
Remodeled Sandersville	Oct. 1, 1978	1978	1979
New Sylvester 70	Nov. 17, 1979	1979	1980
New Millen 33	May 1, 1980	1979	1980

During 1977 and 1979, petitioner purchased and installed heating, ventilating, and air-conditioning (HVAC) units in several of its retail stores. The HVAC units were depreciable property with useful lives of 7 or more years. Petitioner claimed investment tax credits on the HVAC units.

Piggly Wiggly's stores used a variety of open-front refrigerated display cases purchased from several different manufacturers. Because the stores depended on high volume sales to stay in business, open-front cases were a necessity. The cases are designed for use in stores where temperature and humidity were controlled. The specifications on these cases stated the following: "Important: Operating ambient limits for this case of 75 [degrees] Fahrenheit, 55% relative humidity." No open-front cases were available without these environmental requirements. In previous years, before the advent of open-front cases, petitioner had operated stores without air-conditioning.

If the cases are operated at higher temperature and humidity levels, their coils ice over, the cases malfunction, and the food displayed, spoils. Without air-conditioning, the cases can only operate for a short period of time. In 1979, petitioner was required by Federal energy conservation measures to raise the temperature in its stores. Petitioner issued a memorandum outlining the following problems resulting from raising the thermostat settings:

1. Our fresh meat cases are not keeping the product cold enough on the surface of our display cases. As a result, at #151 our pullbacks have

increased by 50% more than normal. Other markets are experiencing similar increases in product that is losing its bloom inmaterially.

2. Our fresh produce department cases are not operating properly. The product is not holding up to the normal shelf life.

3. Our upright freezers are icing up more. The cold air is falling away from the cases more than normal.

4. Our chest type freezer cases are not holding product frozen on the top layers, especially ice cream and juices.

We have put a thermometer in the center of our store and found it to be as warm as 85 [degrees] in some stores.

We have talked to Mr. Joe Justice, our refrigeration man here, and he has told us that these cases are designed to function under certain limited conditions in air conditioned buildings, and by [sic] setting the adjustments lower on our motors is not the answer to keeping our product in our cases. We tried to lower our case temperature at #175 meat case and discovered the product frozen on the bottom and loss of bloom (turned dark) on top.

We realize it's early to measure the loss it's costing us in product, but it is and can be substantial if we have to keep our thermostats set on 75 [degrees].

The Department of Energy (DOE) created exemptions to the conservation measures. The explanation accompanying the proposed DOE regulations, 44 Fed. Reg. 31928 (1979), states:

Proposed section 490.31(a)(3) is intended to avoid health hazards where certain temperature and humidity levels are required for the proper storage and handling of food and other agricultural commodities. By way of illustration, this section would exempt supermarkets and grocery stores where temperature and humidity levels other than those mandated in the regulations are required to preserve produce or for the proper refrigeration of perishable items on open shelf units.

Because of its problems with its refrigerator cases, Piggly Wiggly swiftly obtained an exemption to the DOE conservation requirements.

A pamphlet published by the Food Marketing Institute (FMI), entitled, "Why Is It So Cold In Here?" addressed the use of air-conditioning in supermarkets. It stated, in pertinent part:

Q. Why don't supermarkets cut their air conditioning in the summer, to save energy and to make it less cold?

A. Unlike other commercial buildings, supermarkets do not base air conditioning on comfort considerations. Rather, air conditioning works together with the refrigerators in keeping perishable foods at proper temperature.

Petitioner's manager of refrigeration and energy systems during the years in issue was Benny Smith (Smith). We found Smith to be a forthright, knowledgeable, and credible witness. The air-conditioning systems placed in petitioner's stores were designed by Smith. Smith's choice of systems and designs was based upon the needs of the refrigeration equipment in the stores, and not upon considerations of customer comfort. One reason the HVAC units were selected was because they are designed to meet, automatically, the 55-percent relative humidity requirements of the refrigerator cases.

The HVAC units operated 24 hours a day, and were not hooked up to a duty cycling system. The units operated while the stores were closed to remove moisture from the air, and enabled the cases to continue functioning. The units were required to cool and heat entire stores because the refrigerated cases were placed throughout the stores. Several diffusers were placed over the cash register areas because the customers standing in line and the registers generated heat. The HVAC units weighed 800 to 1000 pounds and could be removed. Petitioner occasionally removed and replaced the units. The units were attached to the ceilings of the stores with simple braces and bolts.

Respondent submitted a brief expert witness report prepared by Denis Nonaka (Nonaka) a "valuation engineer." A valuation engineer renders technical advice on depreciation, investment credit, and allocation of purchase price issues. Nonaka did not have a degree in engineering and had no experience in refrigeration or the food store industry. Nonaka's report relies heavily upon the text of a speech given by an official of the Warren-Sherer refrigeration company. The speech deals generally with the entire food store industry. The report quotes only the first sentence of the following paragraph found on page eight of the speech:

> The Environmental System for a supermarket must not be designed only to heat or cool the market for customer comfort, but provide precise control of the temperature and humidity with minimum drafts or stagnation of air around the refrigerated fixtures. You might compare the need of precise control of the supermarket environment to that of a computer room in that the environment is maintained for maximum operating performance of the equipment within the space. It is the heart of energy management in the supermarket and properly sizing the air conditioning unit is the first step to precise environmental control.

OPINION

Machinery and Equipment

In the notice of deficiency issued to petitioner, respondent determined that Piggly Wiggly was not entitled to depreciation deductions and investment tax credits on new equipment used in its new, relocated, and remodeled stores because the equipment was not placed in service during the fiscal years in which the deductions and credits were claimed.

Section 167(a) provides in part:

> There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
>
> (1) of property used in the trade or business, or
>
> (2) of property held for the production of income.

Section 1.167(a)–10(b), Income Tax Regs., provides that the "period for depreciation of an asset shall begin when the asset is placed in service." Section 1.167(a)–11(e)(1)(i), Income Tax Regs., provides:

> Property is first placed in service when first placed in a condition or state of readiness and availability for a specifically assigned function * * *. In general the provisions of paragraph (d)(1)(ii) and (d)(2) of section 1.46–3 shall apply for the purpose of determining the date on which property is placed in service * * *

Section 1.46–3(d) provides in pertinent part:

> (1) For purposes of the credit allowed by section 38, property shall be considered placed in service in the earlier of the following taxable years:
>
> (i) The taxable year in which, under the taxpayer's depreciation practice, the period for depreciation with respect to such property begins; or
>
> (ii) The taxable year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function * * *
>
> (2) In the case of property acquired by a taxpayer for use in his trade or business (or in the production of income), the following are examples of cases where property shall be considered in a condition or state of readiness and availability for a specifically assigned function: * * *
>
> (ii) Operational farm equipment is acquired during the taxable year and it is not practicable to use such equipment for its specifically assigned function in the taxpayer's business of farming until the following year.

Depreciation and investment tax credits are not allowed on assets acquired for a business that has not begun operations.

Richmond Television Corp. v. United States, 354 F.2d 410 (4th Cir. 1965). See also *Simonson v. United States*, 752 F.2d 341 (8th Cir. 1985); *Petrich v. Commissioner*, 676 F.2d 712 (9th Cir. 1982), affg. without published opinion a Memorandum Opinion of this Court.

As a general rule, an asset subject to depreciation and the investment tax credit is clearly considered as placed in service when it is acquired and put into use in a trade or business. See *Cooper v. Commissioner*, 542 F.2d 599 (2d Cir. 1976), affg. a Memorandum Opinion of this Court; *Madison Newspapers, Inc. v. Commissioner*, 47 T.C. 630, 633 (1967).

As indicated by the regulation, the "placed in service" requirement is met when an asset is in a state of readiness and available for a specifically assigned function in an operating trade or business. In *Schrader v. Commissioner*, 582 F.2d 1374 (6th Cir. 1978), affg. a Memorandum Opinion of this Court, depreciation was allowable with respect to an air-conditioner even though, because of weather conditions, the taxpayer did not actually use the air-conditioner until the following year.

Sears Oil Co. v. Commissioner, 359 F.2d 191 (2d Cir. 1966), revg. on this issue a Memorandum Opinion of this Court, and *SMC Corp. v. United States*, an unreported case (E.D. Tenn. 1980, 46 AFTR 2d 80–5827, 80–2 USTC par. 9642), affd. per curiam 675 F.2d 113 (6th Cir. 1982), represent the only other instances where depreciation and investment tax credits were allowed on property not yet in use.

In *Sears Oil* the taxpayer purchased a canal barge, which it was unable to use until the following year because the canal was frozen. The Second Circuit (359 F.2d at 198), found that the taxpayer was entitled to depreciation in the year of purchase because the barge was gradually deteriorating since it was "subject to the weather elements," because the freezing of the canal was "not a condition which the taxpayer desired to bring about," and because "depreciation may be taken when depreciable property is available for use 'should the occasion arise,' even if the property is not in fact in use." In arriving at this finding the Second Circuit noted that the taxpayer was already in the business for which the depreciable asset had been purchased.

In *SMC Corp.* the taxpayer purchased a scrap shredder and a crane which it was unable to use until the following fiscal

year because the power company had failed to connect the electrical lines needed to run the equipment. The Tennessee District Court relied on the decision in *Sears Oil*:

> In *Sears Oil* every prerequisite to the use of the barge had been completed prior to the end of the fiscal year. Similarly, SMC Corporation's equipment had been completely constructed or assembled * * *. The only impediment to the operation of the equipment was the lack of a permanent supply of electric power * * * which was outside the control of the taxpayer. In *Sears Oil* the only impediment to the operation of the barge was a frozen canal.

Finding that the taxpayer should not be "penalized" for the failure of the electric company, the District Court allowed the taxpayer's claims for depreciation deductions and investment tax credits.

In the instant case, the determinations of respondent are presumptively correct and the burden is on petitioner to prove entitlement to the claimed depreciation and credits. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a). Respondent determined that the equipment in petitioner's new, relocated, and remodeled stores was not placed in service during the fiscal years claimed by petitioner.

We disagree with respondent's determination with regard to the four remodeled stores. Respondent placed great weight on the "opening" of these stores in the fiscal years subsequent to the purchase of the equipment. However, it is clear from the evidence that these "openings" served primarily promotional purposes and did not relate to the installation and use of the new equipment. We find that the equipment in these four stores, which was installed, operating, and in use, in the years purchased, was placed in service during the fiscal years in which the equipment was purchased. Therefore, we hold for petitioner with regard to the depreciation deductions and investment tax credits claimed for the equipment in the four remodeled stores.

Petitioner asserts that it is also entitled to the depreciation and credits claimed with regard to the equipment installed in the new and relocated stores. Citing *Sears Oil Co. v. Commissioner, supra*, and *SMC Corp. v. Commissioner, supra*, petitioner argues that the equipment need not actually be used to be placed in service, but need only be available for use "should the occasion arise." Petitioner contends that since the equipment was operational, aging, and available for use in the new

stores, it was placed in service during the fiscal years in which the equipment was purchased rather than the later fiscal years in which the stores opened for business.

We do not agree with petitioner's analysis. The equipment was placed in stores that were not yet open for business. The common thread found in *Schrader, Sears Oil, SMC Corp.*, and the regulation examples is that the taxpayers already were engaged in the business for which the equipment was purchased.

Furthermore, the taxpayers in those instances had done all that was in their power to place the equipment into service. Weather conditions prevented the taxpayer in *Schrader* from using the air-conditioner, and prevented the taxpayer in *Sears Oil* from using the barge in the years the equipment was purchased. In *SMC Corp.*, the power company's actions stopped the taxpayer from using its crane and shredder.

In the instant case, the opening of the new and relocated stores was wholly within the control of Piggly Wiggly. The cost of the equipment did not contribute to, and therefore should not be charged against, income for an accounting period prior to the years in which the stores opened for business. See *Massey Motors, Inc. v. United States*, 364 U.S. 92, 104 (1960).

Equipment located in retail stores, which is to be used in connection with the trade or business conducted in those stores, is placed in service upon the opening of the stores. We find that petitioner failed to satisfy the placed in service requirements of sections 1.167(a)–10(b), 1.167(a)–11(e)(1), and 1.46–3(d), Income Tax Regs., and, therefore, uphold the determination of respondent disallowing the claimed depreciation deductions and investment tax credits for the equipment in the new and relocated stores. We have considered petitioner's other arguments and find them unpersuasive.

HVAC Units

The second issue for consideration is whether the HVAC units installed by petitioner in its supermarkets qualify as section 38 property for investment tax credit purposes.

Section 38 allows a credit against tax for investments in certain types of property, described as "section 38 property." In relevant part, section 48(a) states:

(1) IN GENERAL.—Except as provided in this subsection, the term "section 38 property" means—

(A) tangible personal property (other than an air conditioning or heating unit),[4] or

(B) other tangible property (not including a building and its structural components) but only if such property—

(i) is used as an integral part of manufacturing, production, or extraction * * *

Petitioner initially argues that its preparation of meat for retail sale places it in the business of manufacturing or producing for purposes of section 48(a)(1)(B)(i). Petitioner's stores, however, were retail supermarkets, and were held out as such to the public. Activities involving the sale of merchandise and food to the general public for personal or household consumption and the rendering of services incidental to the sale of such goods are considered retail activities rather than manufacturing or producing activities. See Rev. Rul. 81–66, 1981–1 C.B. 19, 20. The meat prepared in petitioner's stores was for direct sale to and consumption by the general public. Thus, the preparation of meat was incidental to petitioner's retailing activities, and was not among the activities encompassed by section 48(a)(1)(B)(i).

In order to qualify as section 38 property, the HVAC units must be tangible personal property under section 48(a)(1)(A). Section 1.48–1(c), Income Tax Regs., provides in pertinent part:

For purposes of this section, the term "tangible personal property" means any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are stuctural components of such buildings or structures). Thus, buildings, swimming pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property. Tangible personal property includes all property (other than structural components) which is contained in or attached to a building.

Pursuant to section 38(b), respondent, in section 1.48–1(e)(2),[5] Income Tax Regs., defined the term "structural components" as follows:

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[4] The parenthetical language was added to sec. 48(a)(1)(A) by sec. 301(d)(1) of the Energy Tax Act of 1978, Pub. L. 95–618, 92 Stat. 3174, 3199 (1978), for equipment placed in service after September 1978.

[5] This regulation does not reflect the amendments made by the Energy Tax Act of 1978. See note 4.

The term "structural components" includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as panelling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; * * * and other components relating to the operation or maintenance of a building. *However, the term "structural components" does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the "sole justification" test provided by the preceding sentence even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential.* For example, an air conditioning and humidification system installed in a textile plant in order to maintain the temperature or humidity within a narrow optimum range which is critical in processing particular types of yarn or cloth is not included within the term "structural components." * * * [Emphasis added]

This Court has held that section 1.48–1(e)(2), Income Tax Regs., represents an accurate interpretation of congressional intent with respect to the treatment of heating and air-conditioning equipment and has determined that the regulation has the full force and effect of law. *Fort Walton Square, Inc. v. Commissioner*, 54 T.C. 653, 661 (1970). See *Samis v. Commissioner*, 76 T.C. 609, 619 (1981).

In *Fort Walton Square, Inc. v. Commissioner*, *supra*, we found that a shopping center's rooftop air-conditioning and heating systems constituted "structural components" of the building. See also *Dixie Manor, Inc. v. United States*, an unreported case (W.D. Ky. 1979, 47 AFTR 2d 81–1298, 79–2 USTC par. 9469), affd. without published opinion 652 F.2d 57 (6th Cir. 1981). In *Kramertown Co. v. Commissioner*, 488 F.2d 728 (5th Cir. 1974), affg. a Memorandum Opinion of this Court, the rooftop air conditioners of a shopping center were held to be components of a central air-conditioning system and, thus, constituted "structural components." The Fifth Circuit in *Kramertown Co.* stated at page 731, that:

The motors and compressors of most central air conditioning units are capable of being removed and replaced by relatively simple mechanical methods. Thus, the quality of removability is not the sole determinant of whether a piece of machinery is a structural component. The weight, location and capacity of these storewide rooftop units are all indications of the reasonableness of classifying these machines of [sic] structural components of the buildings they serve under * * * a permanency test.

This Court held in *Circle K Corp. v. Commissioner*, T.C. Memo. 1982–298, that air-conditioning units installed in convenience stores were structural components and were not section 38 property. We rejected the taxpayer's argument that the units were "individual units" and found that they were part of a central air-conditioning system. The fact that the units might be removed did not affect their status as "structural components." We also rejected the taxpayer's contention that under section 1.48–1(e)(2), Income Tax Regs., the air-conditioning units were not structural components because they were installed to meet temperature or humidity requirements. The units were not essential to the taxpayer's operation of any machinery or processing of materials or foodstuffs. Since the failure to have air-conditioning would have placed the taxpayer at a competitive disadvantage, we found that "a substantial reason for the installation of the air conditioning units was to provide for the comfort of petitioner's customers, a purpose that is outside the scope of the regulatory exception."

In the instant case, the HVAC units installed by petitioner are, without consideration of the sole justification test, "structural components" as defined by section 1.48–1(e)(2), Income Tax Regs.[6] However, the evidence presented by petitioner clearly establishes that the sole justification for the installation of the HVAC units was the necessity to meet the temperature and humidity requirements of the refrigeration equipment in petitioner's stores.

The equipment specification sheets, the FMI pamphlet, and the testimony of Smith all showed that petitioner's equipment required environmental limits of 75 degrees Fahrenheit and 55 percent humidity. The HVAC units were designed specifically to meet these environmental limits. In 1979, the DOE recognized petitioner's need to operate its equipment within these environmental limits and granted petitioner an exemption to the regulations requiring higher thermostat settings. At higher temperatures, petitioner's equipment would ice up and then cease to function, spoiling the food contained in the cases.

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[6]There is no dispute that the HVAC units constructed a central air-conditioning system.

In *Fort Walton Square, Inc. v. Commissioner, supra*, the issue was whether air-conditioning and heating units were part of a central system and thus constituted structural components. In *Fort Walton Square*, as in *Kramertown Co.*, the purpose of the systems in the shopping centers was clearly customer convenience, and there was no argument that the systems were essential to the operation of machinery. Here, petitioner does not contest the fact that the HVAC units are a central system, but instead argues that the HVAC units are not structural components because they are essential to the operation of the refrigerator cases. Thus, the instant case is distinguishable from the prior cases, which do not reach this further issue.

This Court considered whether an air-conditioning system in a convenience food store qualified as section 38 property in *Circle K Corp. v. Commissioner, supra*. We found that the system was not essential to the operation of any machinery. Petitioner has distinguished his case from *Circle K Corp.*, pointing to the differences in operation of a convenience store and a supermarket. Convenience stores use closed-door refrigerator cases, while high-volume-dependent supermarkets must use open-front cases, which require environmental conditions unnecessary for the operation of closed-door cases.

Respondent asserts that the HVAC units were installed to allow petitioner to compete with other air-conditioned supermarkets in attracting customers. The evidence submitted by respondent to support this argument and to rebut petitioner's evidence consists of the brief expert witness report prepared by Nonaka. Nonaka had no experience in refrigeration or the food store industry. His report relies heavily on a speech given by a refrigeration company official dealing in general terms with the entire retail supermarket industry. From these generalities, Nonaka concludes that petitioner's HVAC units were installed for worker and customer comfort, and not to meet the needs of the equipment. Nonaka's report errs in its failure to look at facts relating to petitioner's specific situation. For example, petitioner does not employ duty cycling and never operated an un-air-conditioned supermarket with open-front cases. Further, by picking and choosing, Nonaka's report only quoted and relied on the language in the speech that supported his position. Because Nonaka had no experience with the food store industry and because his short report

contains errors and generalizations, we afford it little evidentiary weight.

Respondent's arguments in support of his position are similarly flawed. Attacking petitioner's assertion that the HVAC units are essential to the operation of the equipment, respondent points to the absence of humidity registers in the stores, despite the fact that the HVAC units are designed to meet the humidity requirements without such registers. Further, respondent alleges that the impaired functioning of the refrigerator cases prior to petitioner's obtaining an exemption constitutes proof that the equipment can work without environmental controls.

Respondent argues that the environmental control provided by the HVAC units was primarily for petitioner's workers and customers. The operation of the HVAC units indubitably benefited petitioner's workers and customers. However, based on the evidence, this was a collateral benefit, incidental to the maintenance of proper environmental conditions for the operation of petitioner's machinery. It is bootstrapping to argue, post hoc ergo propter hoc, that where a collateral benefit necessarily follows an action, that the collateral benefit belies another basis as the justification for the action. See *Westroads, Inc. v. Commissioner*, 69 T.C. 682 (1978). We find petitioner's sole justification for the installation of the HVAC units in its stores was that the HVAC units were essential to meet the temperature or humidity requirements for the operation of its refrigeration equipment, and that the benefit to petitioner's workers and customers was incidental. Thus, we find that pursuant to section 1.48–1(e)(2), Income Tax Regs., petitioner's HVAC units met the exception to the term "structural components."

Section 1.48–1(e)(2), Income Tax Regs., defines central air-conditioning and heating systems as structural components unless the "sole justification" test is met. When such systems are not considered structural components because they meet the sole justification test, they may be considered property in the nature of machinery, and, thus, qualify as tangible personal property without further examination of their inherent permanence.[7]

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[7] In *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664, 672–673 (1975), this Court established a six-question test to determine whether property other than machinery qualifies as tangible

Having found that petitioner's HVAC units are not structural components because they meet the sole justification test, we hold that the units installed in 1977 were tangible personal property under section 48(a)(1)(A), and, therefore, were qualified section 38 property for purposes of investment tax credit. Before we may rule on the HVAC units installed in 1979, however, a final issue of statutory interpretation remains to be examined.

The Energy Tax Act of 1978, Pub. L. 95–618, 92 Stat. 3174, added the language "(other than an air conditioning or heating unit)" to section 48(a)(1)(A). This Court must consider the meaning of this parenthetical language.

On its face, the parenthetical appears to exclude all air-conditioning and heating units from the "tangible personal property" category, including central air-conditioning and heating meeting the sole justification exception in section 1.48–1(e)(2), Income Tax Regs.[8] For aid in determining the meaning of the statutory language, we look to the legislative history, which illuminates congressional intent.

The House Committee on Ways and Means proposed the amendment to section 48(a)(1)(A), in the same language in which it was enacted, as a part of the measures that became the Energy Tax Act of 1978 (act). The report of the House Committee on Ways and Means (Ways and Means report) H.R Rept. 95–496, at 124 (1978), 1978–3 C.B. (Vol. 2) 71, 77, which accompanied the proposed act, characterized the act as: "an effort to curtail the rate of growth of domestic energy consumption." The Ways and Means report (1978–3 C.B. (Vol. 2), at 186) explained the amendment to section 48(a)(1)(A) as follows:

> Under the committee bill several tax incentives would be repealed for new investments in certain energy property. In particular, the committee bill deletes air conditioning and space heating units (that is, those not considered structural components) from the definition of tangible personal property so that such property no longer will be eligible for the regular investment tax credit.

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personal property for purposes of the investment tax credit. Respondent adopted this test. Rev. Rul. 80–151, 1980–1 C.B. 7, 8. We believe that even if this test were applicable in the instant case, petitioner's HVAC units would meet the six criteria.

[8] For a discussion of the problems in interpreting the sec. 48(a)(1)(A) parenthetical, see Bradley & Oliver, "Investment Tax Credit: The Illusory Incentive," 2 Va. Tax Rev. 267, 304–310 (1983).

The Senate version of the act did not contain the parenthetical amendment to section 48(a)(1)(A). The Conference report, S. Rept. 95–1324 (Conf.), at 67 (1978), 1978–3 C.B. (Vol. 2) 309, 339, however, adopted the amendment, stating that under the House version: "Portable air conditioners and space heaters would also be ineligible to receive the investment credit." The Conference report, *supra*, goes on to state that the "conference agreement generally follows the House provision," and that it applies "only to portable air conditioners, portable space heaters and boilers fueled by oil or gas."

The Joint Committee on Taxation, Summary and Section-by-Section Explanation of Title II of H.R. 8444, 95th Cong., 1st Sess. 29 (1977), (Joint Committee report) states that: "Under this provision, the regular investment credit is denied for portable air conditioners and heaters, which tend to use energy inefficiently."

Although the language in the Ways and Means report appears ambiguous, when combined with the statements in the Conference report and the Joint Committee report, it is clear that Congress intended to exclude only portable air-conditioning and heating units from section 48(a)(1)(A). Though noting that the term "portable" was not defined, respondent has acknowledged that Congress intended this provision to apply only to portable units. See Rev. Rul. 81–240, 1981–2 C.B. 11. This Court took note of the congressional intent behind the provision in *Circle K Corp. v. Commissioner, supra* at n. 7.

The language in the Ways and Means report regarding units considered to be structural components indicates that Congress intended that the units excluded are those commonly thought of as portable air-conditioners and space heaters. Congress did not seek to exclude central air-conditioning and heating units that would be considered structural components but for the "sole justification" exception. This intent is in line with the articulated policy of the act, to discourage the inefficient usage of energy.

In the instant case, petitioner did not establish that the HVAC units upon which it claimed the investment tax credit for the fiscal year 1979 were placed in service prior to September 30, 1978. The HVAC units, however, were not what are commonly considered portable air-conditioners or heaters.

Though movable, the HVAC units would have been considered structural components if they had failed to meet the sole justification exception. See *Kramertown Co. v. Commissioner, supra.* Thus, we find that the HVAC units were not excluded from the definition of tangible personal property. We hold that the HVAC units petitioner installed in 1979 were also tangible personal property under section 48(a)(1)(A), and, therefore, were qualified section 38 property for purposes of the investment tax credit. We have considered respondent's other arguments and find them unpersuasive.

Based on the foregoing,

Decision will be entered under Rule 155.

TAMARISK COUNTRY CLUB, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 1652–83. Filed April 24, 1985.

P, a tax-exempt social club under sec. 501(c)(7), I.R.C. 1954, purchased land in 1972 to expand its recreational facilities. P sold the land and realized gain in 1974. Within the 4-year period commencing 1 year before the sale and ending 3 years after the sale, P purchased other property for an amount less than the consideration it received on the land sale less selling expenses. *Held*: P's realized 1974 gain is recognized. The nonrecognition provisions of sec. 512(a)(3)(D), I.R.C. 1954, do not apply. Sec. 512(a)(3)(D), I.R.C. 1954, requires that gain realized on the sale of property used directly in the performance of the exempt function of a "sec. 501(c)(7) organization" be recognized, to the extent that the consideration for the sale, less selling expenses and expenses for work performed to assist in the sale of the property, exceeds the cost of other property purchased by the organization and used directly in the performance of its exempt function.

Richard J. Sideman, for the petitioner.
Michael C. Cohen, for the respondent.

OPINION

GERBER, *Judge*:* Respondent, in a November 4, 1982, statutory notice, determined a deficiency of $44,592 in petitioner Tamarisk Country Club's Federal income tax liability for its taxable year ended September 30, 1974. We must decide the extent to which the gain realized by petitioner, a tax exempt social club, on the sale of property used directly in the performance of its exempt function must be recognized pursuant to section 512(a)(3)(D).[1]

The parties have stipulated to the facts in this case. Their stipulation of facts and accompanying joint exhibits are incorporated by this reference.

Petitioner is an organization exempt from taxation under section 501(c)(7). Its principal place of business is located in Rancho Mirage, California, and its principal activity is the operation of a private golf club for its members. For its taxable year ended September 30, 1974, petitioner filed with the Internal Revenue Service Center in Philadelphia, Pennsylvania, a Return of Organization Exempt From Income Tax (Form 990) and an Exempt Organization Business Income Tax Return (Form 990-T).

On April 24, 1972, petitioner purchased a 55-acre tract of land adjacent to its existing facilities. The new property was to be used either for expansion of the club's golf course or for construction of other related recreational facilities. There was no intent to hold the 55-acre tract as an investment. The purchase price of the land was $643,218, including $1,654 for fees incident to the purchase. Petitioner deposited $100 cash, assumed existing trust deeds of $379,430 on the property, and paid the remainder of the purchase price in cash from the proceeds of an unsecured bank loan of $262,033.78. To raise funds to pay for the land, petitioner, pursuant to a resolution of its membership, assessed each member $1,250, payable in five annual installments of $250 each and refundable upon death or resignation from the club. This assessment resulted in the collection of $318,500 from petitioner's membership.

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*By order of the Chief Judge, this case was reassigned from Judge C. Moxley Featherston to Judge Joel Gerber for disposition.

[1]Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the year at issue.

These collected funds were applied to reduce the amount owing on the deeds of trust that had been assumed at the time of purchase.

Membership in petitioner began to decline in mid-1973, and by November 1973 it became apparent that petitioner might be unable to finance the projects proposed for the acquired land. The membership considered the situation and voted in favor of selling the property. On March 26, 1974, petitioner sold the property for a total consideration of $850,000 in cash.

At the time of sale, petitioner's adjusted basis in the property was $695,819, including interest and taxes that petitioner had elected to capitalize under section 266. Petitioner incurred $5,541 in selling expenses and realized a gain of $148,640 on the sale. The sale proceeds were applied as follows:

Refund of membership assessments	$318,500
Full payment of note (including interest) from bank loan	265,000
Selling expenses	5,541
Retained by petitioner as of Mar. 26, 1974	260,959
	850,000

During the 4-year period beginning March 26, 1973 (1 year prior to the sale of the land), and ending March 26, 1977 (3 years subsequent to the sale of the land), petitioner purchased property used directly in the performance of its exempt function with a total cost of $305,511.[2]

On its Form 990 for the taxable year ended September 30, 1974, petitioner claimed that recognition of its realized gain on the land sale was deferred pursuant to section 1.512(a)–3(e), Proposed Regs.[3] Respondent in his statutory notice determined that the gain realized upon the sale constituted unrelated business taxable income in the amount of $148,640, taxable in petitioner's fiscal year ended September 30, 1974.

Petitioner's purchase and sale of land and subsequent purchase of other property raise the issue of the amount of gain, if any, petitioner must recognize on its sale of the 55-acre

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[2] No new land was purchased. Expenditures were made for golf carts, land improvements, and other items. Sec. 512(a)(3)(D) does not require the new property to be similar in kind or use to the old.

[3] Sec. 1.512(a)–3(e), Proposed Regs., sets forth rules applicable to the nonrecognition of gain under sec. 512(a)(3)(D).

tract of land. In general, gain realized from the sale of property is recognized. Secs. 1001(c), 1002. Congress has permitted nonrecognition and deferral of gain in certain circumstances, such as like-kind exchanges (section 1031) and sale and acquisition of a principal residence (section 1034). This case involves the construction of section 512(a)(3)(D), which provided, in pertinent part, as follows:

> SEC. 512. UNRELATED BUSINESS TAXABLE INCOME.
> (a) DEFINITION.—For purposes of this title—
>
> * * * * * * *
>
> (3) SPECIAL RULES APPLICABLE TO ORGANIZATIONS DESCRIBED IN SECTION 501(c)(7) OR (9).—
>
> * * * * * * *
>
> (D) NONRECOGNITION OF GAIN.—If property used directly in the performance of the exempt function of an organization described in section 501(c)(7) or (9) is sold by such organization, and within a period beginning 1 year before the date of such sale, and ending 3 years after such date, other property is purchased and used by such organization directly in the performance of its exempt function, gain (if any) from such sale shall be recognized only to the extent that such organization's sales price of the old property exceeds the organization's cost of purchasing the other property. For purposes of this subparagraph, * * * rules similar to the rules provided by subsections (b), (c), (e), and (j) of section 1034 shall apply.

To our knowledge, this nonrecognition provision has not previously been construed.

Section 511(a) imposes a tax on the unrelated business taxable income of "section 501(c)(7) organizations."[4] "Unrelated business taxable income" is essentially gross income, excluding membership dues and fees, less allowable deductions directly connected with the production of gross income. Sec.

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[4] SEC. 511. IMPOSITION OF TAX ON UNRELATED BUSINESS INCOME OF CHARITABLE, ETC., ORGANIZATIONS

(a) CHARITABLE, ETC., ORGANIZATIONS TAXABLE AT CORPORATION RATES.—

(1) IMPOSITION OF TAX.—There is herby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in paragraph (2) a normal tax and a surtax computed as provided in section 11. In making such computation for purposes of this section, the term "taxable income" as used in section 11 shall be read as "unrelated business taxable income".

512(a)(3)(A) and (B).[5] As noted, respondent determined that petitioner's realized gain of $148,640 on the land sale constituted "unrelated business taxable income," and determined petitioner's tax liability for the taxable year ended September 30, 1974, as $44,592. Petitioner maintains that no recognizable gain arose from the sale of the land and the subsequent purchase of other property.[6]

Petitioner contends that section 512(a)(3)(D) permits nonrecognition so long as the "price of the *organization's* equity in the old property does not exceed the cost of the *organization's* equity in the new property." According to petitioner, if all profits are reinvested in property that is also used for exempt purposes, no gain is to be recognized.[7] Petitioner asserts that under section 512(a)(3)(D), the "organization's sales price" of the land is $260,959. The $260,959 result is arrived at by subtracting from the $850,000 proceeds of the sale, selling expenses ($5,541), amounts spent to discharge the indebtedness on the unsecured loan ($265,000), and the refund of the membership assessment ($318,500). Since the cost of purchasing other property was $305,511, an amount higher than the

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[5] SEC. 512. UNRELATED BUSINESS TAXABLE INCOME.
(a) DEFINITION.—For purposes of this title—

* * * * * * *

(3) SPECIAL RULES APPLICABLE TO ORGANIZATIONS DESCRIBED IN SECTION 501(c)(7) OR (9).—
(A) GENERAL RULE.—In the case of an organization described in section 501(c)(7) or (9), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income), both computed with the modifications provided in paragraphs (6), (10), (11), and (12) of subsection (b).
(B) EXEMPT FUNCTION INCOME.—For purposes of subparagraph (A), the term "exempt function income" means the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. * * *

[6] Petitioner offered two exhibits to which respondent has objected on grounds of relevance. Each exhibit consists of a letter to petitioner from a certified public accountant. One letter addresses the tax consequences of the sale of petitioner's land and the other relates to petitioner's purchases of new property following the sale. To the extent that these letters provide background information to assist the Court in understanding petitioner's arguments, they are received in evidence.

[7] Petitioner's position is somewhat unclear. We are not certain whether petitioner is asserting that reinvestment of profits or the seller's equity meets the requirements for nonrecognition. Petitioner's gain on the land sale was $148,640. The amount retained from the sale proceeds, which petitioner regards as its equity, was a greater amount, $260,959.

In any event, we regard petitioner's computation of its equity in the 55-acre tract as incorrect. Equity has been defined as the value of a property above the total of the liens. *Crane v. Commissioner*, 331 U.S. 1, 7 (1947). In computing its equity, petitioner subtracted the refundable membership assessment charge. The record, however, does not indicate that the membership had a claim or lien against the land.

amount petitioner contends is the "organization's sales price," petitioner concludes that it had no recognizable gain.

Respondent, in contrast, asserts that petitioner "organization's sales price" under section 512(a)(3)(D) is $844,459, the $850,000 sale proceeds, less $5,541 in selling expenses. According to respondent, the organization's sales price ($844,459) exceeds the cost of the new property ($305,511) by more than the gain realized ($148,640) so that petitioner must recognize the full amount of its realized gain. We agree with respondent and hold that petitioner must recognize the $148,640 gain.

The starting point for interpreting a statute is the language of the statute, itself. E.g., *Rosewell v. LaSalle National Bank*, 450 U.S. 503, 512 (1981); *Consumer Product Safety Commission v. GTE Sylvania*, 447 U.S. 102, 108 (1980). Absent a clearly expressed legislative intention to the contrary, the language of a statute ordinarily must be regarded as conclusive. E.g., *United States v. Turkette*, 452 U.S. 576, 580 (1981); *Consumer Product Safety Commission v. GTE Sylvania, supra* at 108.

According to the express language of section 512(a)(3)(D), "rules similar to the rules provided by subsections (b), (c), (e), and (j) of section 1034 shall apply." Citing no authority, petitioner asserts that section 512(a)(3)(D) should be read without resort to section 1034 until temporary or final regulations are adopted under section 512(a)(3)(D) because "similar rules" will not be established until that time.[8] We disagree. We cannot ignore section 1034 in interpreting section 512(a)(3)(D). To do so would be to disregard the mandate of the statute. Courts, not executive agencies, are the final authorities on questions of statutory construction. E.g., *Volkswagenwerk Aktiengesellschaft v. Federal Maritime Commission*, 390 U.S. 261, 272 (1968). The absence of temporary or final regulations under one section of the Code should not preclude us from interpreting the provision by resort to another Code section to which it refers.

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[8]Respondent, on brief, acknowledges that sec. 1.512(a)-3, Proposed Regs., has not been adopted and states that he does not rely on the proposed regulation to support his position. Proposed regulations are tantamount to a position taken by respondent on brief. *Scott v. Commissioner*, 84 T.C. 683 (1985); *F.W. Woolworth Co. v. Commissioner*, 54 T.C. 1233, 1265-1266 (1970). Because respondent, on brief, does not look to his proposed regulation, we need not consider it further and accord it no weight.

Section 1034 provides for nonrecognition of gain on the sale of a principal residence.[9] Section 1034 does not contain a definition of "organization's sales price" but does contain a definition of "adjusted sales price" as the amount realized on the sale, less expenses for work performed to assist in its sale. Sec. 1034(b)(1). The "amount realized" is the consideration received, less selling expenses. Sec. 1.1034–1(b)(4), Income Tax Regs.; *Allstate Savings & Loan Association v. Commissioner*, 68 T.C. 310, 318 (1977), affd. 600 F.2d 760 (9th Cir. 1979), cert. denied 445 U.S. 962 (1980). To apply section 1034(b) to the facts before us, we subtract petitioner's selling expenses of $5,541 from the $850,000 consideration it received to arrive at its "amount realized," $844,459. By analogy to the definition of "adjusted sales price" in section 1034(b), "organization's sales price" is the amount realized, reduced by the aggregate of the expenses for work performed on the old property to assist in its sale. No work was performed on petitioner's old property to assist in its sale, so petitioner's sales price and its amount realized are the same, $844,459, a sum $538,948 in excess of petitioner's cost of purchasing the other property. Petitioner's gain on the sale is its amount realized ($844,459), less its adjusted basis in the land ($695,819), or $148,640. Sec. 1001(a); sec. 1.1034–1(b)(5), Income Tax Regs. Because petitioner's sales price of the 55-acre tract, less its cost of purchasing the other property, exceeds its gain, the nonrecognition provisions of section 512(a)(3)(D) are not available to petitioner and it must recognize the full amount of its gain on the land sale, $148,640. See *Shaw v. Commissioner*, 69 T.C. 1034, 1036 (1978); *Boesel v. Commissioner*, 65 T.C. 378, 385 (1975) (in both cases, computation of gain recognized under section 1034).

Petitioner vigorously asserts that section 512(a)(3)(D) must be interpreted consistent with the legislative objective in enacting the provision, as set forth by the Senate Finance Committee in S. Rept. 91–552 (1969), 1969–3 C.B. 423, which

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[9] SEC. 1034. SALE OR EXCHANGE OF RESIDENCE.

(a) NONRECOGNITION OF GAIN.—If property (in this section called "old residence") used by the taxpayer as his principal residence is sold by him after December 31, 1953, and, within a period beginning 18 months before the date of such sale and ending 18 months after such date, property (in this section called "new residence") is purchased and used by the taxpayer as his principal residence, gain (if any) from such sale shall be recognized only to the extent that the taxpayer's adjusted sales price (as defined in subsection (b)) of the old residence exceeds the taxpayer's cost of purchasing the new residence.

accompanied the enacting legislation, H.R. 13270, the Tax Reform Act of 1969, 83 Stat. 487, Pub. L. 91–172. Petitioner contends that Congress did not intend that gain be recognized on the facts before us.

The Senate Finance Committee provided the following reasons for changing former law, under which certain income of social clubs was exempt from taxation:

> Since the tax exemption for social clubs and other groups is designed to allow individuals to join together to provide recreational or social facilities or other benefits on a mutual basis, without tax consequences, the tax exemption operates properly only when the sources of income of the organization are limited to receipts from the membership. Under such circumstances, the individual is in substantially the same position as if he had spent his income on pleasure or recreation (or other benefits) without the intervening separate organization. However, where the organization receives income from sources outside the membership, such as income from investments * * *, upon which no tax is paid, the membership receives a benefit not contemplated by the exemption in that untaxed dollars can be used by the organization to provide pleasure or recreation (or other benefits) to its membership. For example, if a social club were to receive $10,000 of untaxed income from investment in securities, it could use that $10,000 to reduce the cost or increase the services it provides to its members. In such a case, the exemption is no longer simply allowing individuals to join together for recreation or pleasure without tax consequences. Rather, it is bestowing a substantial additional advantage to the members of the club by allowing tax-free dollars to be used for their personal recreational or pleasure purposes. The extension of the exemption to such investment income is, therefore, a distortion of its purpose. [S. Rept. 91–552, *supra*, 1969–3 C.B. at 469–470.]

The committee explained the exception to its tax on unrelated business taxable income codified in section 512(a)(3)(D), as follows:

> In addition, the committee's bill provides that the tax on investment income is not to apply to the gain on the sale of assets used by the organizations in the performance of their exempt functions to the extent the proceeds are reinvested in assets used for such purposes within a period beginning 1 year before the date of sale and ending three years after that date. This provision is to be implemented by rules similar to those provided where a taxpayer sells or exchanges his residence (sec. 1034). The committee believes that it is appropriate not to apply the tax on investment income in this case because the organization is merely reinvesting the funds formerly used for the benefit of its members in other types of assets to be used for the same purpose. They are not being withdrawn for gain by the members of the organization. For example, where a social club sells its clubhouse and uses

the entire proceeds to build or purchase a larger clubhouse, the gain on the sale will not be taxed if the proceeds are reinvested in the new clubhouse within three years. [S. Rept. 91–552, supra, 1969–3 C.B. at 470–471.]

Nothing in the committee report pertinent to section 512(a)(3)(D) supports petitioner's argument that it is entitled to nonrecognition of gain to the extent that its "equity" (or "profit") was reinvested in other qualifying property; to the contrary, the cited excerpt refers to reinvestment of the *proceeds* from the sale of property. If Congress intended, as petitioner maintains, that the realized gain on the sale by a section 501(c)(7) organization of property used directly in the performance of its exempt function not be recognized where the equity in the sold property or the profits on the sale are reinvested, it could have said so. See, e.g., *Malat v. Riddell*, 383 U.S. 569, 571 (1966). By discharging the indebtedness on its loan and by currently refunding the assessment, which its membership previously had agreed was refundable only upon death or resignation from the club, petitioner did not "merely reinvest" its funds from the land sale in other types of assets. In the language of the committee report, funds were "withdrawn for gain by the members of the organization," who benefited through decrease in petitioner's debt and return of the assessment. Petitioner's gain therefore constitutes unrelated business taxable income.

Decision will be entered for the respondent.

FRANCINE SCHUSTER, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 20396–82. Filed April 29, 1985.

Petitioner, a nurse-practitioner, was a member of a religious order of the Roman Catholic Church. She sought and was offered a position with a Federal agency that assigns health care professionals to work in regions lacking adequate medical services. After receiving approval from her Order, petitioner accepted the position. Pursuant to her vow of poverty, petitioner endorsed all of her paychecks over to her Order. Held: Petition-

er's wages were earned in her individual capacity, and not as an agent of the Order. Her wages are therefore subject to taxation.

William J. Falk and *Mary Gassmann Reichert*, for the petitioner.

Frank Agostino and *David R. Reed*, for the respondent.

WILBUR, *Judge*: Respondent determined a deficiency in petitioner's 1980 Federal income tax in the amount of $1,529. The sole issue for decision is whether compensation earned by petitioner while she was a member of a religious order is includable in her gross income.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and the attached exhibits are incorporated herein by this reference.

Petitioner resided in Red Bud, Illinois, when she filed her petition in this case. She timely filed her 1980 Federal income tax return with the Kansas City Service Center.

During all relevant times, petitioner was a member, or Sister, in a religious order of the Roman Catholic Church called the Order of the Adorers of the Blood of Christ (the Order). The Order was incorporated under the laws of the State of Illinois on July 24, 1886, as the Convent of the Sisters of the Precious Blood, and is a religious organization exempt from Federal income tax. The Order's corporate objective is stated to be "to conduct schools and places of learning and to promote education, to advance the cause of religious and social work, to conduct hospitals and institutions for the care and treatment of suffering humanity and to do all and everything necessary or convenient for the accomplishment of any of the purposes or objects and powers mentioned or incidental thereto."

Each member of the Order is required to make vows of chastity, obedience, and poverty as a precondition of membership. Petitioner therefore executed a "Declaration Concerning Remuneration" in which she agreed "never [to] claim or demand, directly or indirectly, any wages, compensation, remuneration, or reward * * * for the time or for the services or work that I devote for * * * [the Order] during the time I

may remain there or elsewhere in the name of or upon commission from said [Order]."

A member who wishes to withdraw from the Order may receive official dispensation from her vows by application through her provincial superior to the general superior of the Order. In addition, some members have withdrawn from the Order without obtaining dispensation from the Church. Members who withdraw from the Order are entitled to receive the personal property they owned before joining the Order, as well as property received by gift or inheritance. In addition, withdrawing members are entitled to the return of their dowries, if they had them. The procedures set forth in the Order's constitution for the return of property to withdrawing members do not vary for members who fail to obtain official dispensation from their vows.

Members of the Order are allowed to secure employment (called missions) in occupations that relate to the Order's general purposes, subject to approval by a Provincial Superior of the Order. The Provincial Superior's approval turns upon whether the proposed mission is in accordance with the Order's interpretation of the Gospel of Jesus Christ; that is, whether the mission relates to religious and charitable works that promote education, relieve suffering, and otherwise provide assistance to those in need.

When a member takes a vow of obedience as a precondition to her membership in the Order, she expressly promises to subjugate her will to that of the Order. Pursuant to that vow, no member may accept a mission without the approval of the Order. Each member who receives a missioning order is under a duty to obey that order and cannot voluntarily terminate the mission without the Order's prior approval. In addition, each member promises to abide by any direction of the Provincial Superior, even if such direction relates to the performance of the mission itself, or requires the member's withdrawal from the mission. The Order has at times required members to terminate their assigned missions.

Pursuant to their vows, members of the Order are not entitled to retain any funds generated by their mission work; rather, the Order is entitled to all such funds. Thus, the Order requires its members to submit any payments made to a member in respect of a mission. After the member transfers

the funds to the Mother House, the member maintains no control over the Order's disposition of the funds. If a member who has engaged in mission work subsequently leaves the Order, the constitution of the Order provides that "A sister who withdraws may not demand remuneration for her work as a member of the community, since, like all the Adorers of the Blood of Christ, she freely chose to serve the Lord and His people in a life of poverty, without personal gain. The community, however, in charity will help her provide for her immediate needs when she leaves."

When a member of the Order is missioned in a location that is not impracticably far away from the Mother House of the Order, the member generally lives in the convent. When, on the other hand, a mission is not located near a convent, the Order rents a residence for the member. Any house rented by the Order for these purposes is considered within the Order to constitute a convent. Each member living away from the Mother House of the Order is required to submit to the Order a monthly budget statement setting forth her living expenses. The Order then either approves or revises the proposed budget, and pays the member's monthly living expenses, as approved. In addition, the Order provides its members with a maximum allowance for personal expenses which, during the year at issue, was $35 per month. There is no relationship between the amount of a member's monthly allowance and the amount of funds, if any, generated by her mission work.

Petitioner made her perpetual vows of poverty, chastity, and obedience in 1970 and became a perpetual member of the Order at that time. She has never requested dispensation from her vows, and at all relevant times was an active member of the Order.

In June, 1968, petitioner received her bachelor of science degree in nursing. On October 18, 1978, petitioner was awarded a traineeship for Nurse Practitioner training under section 882(b) of the Public Health Services Act. This award covered the cost of petitioner's tuition, living and moving expenses, books and fees in the nurse midwife program at the University of Mississippi's medical center. In order to receive the traineeship award, petitioner agreed that upon completion of her traineeship she would reside and practice in a "health manpower shortage area" (as defined by section 332 of the Public

Health Services Act) for a 12-month period for each academic year for which the traineeship award was made. Petitioner agreed that if she failed to fulfill her "practice commitment" she would "pay back within 12 months of the date of completing the training, the amount of all traineeship assistance received, plus interest set by the Treasury."

From February 28, 1978, through May 12, 1979, petitioner attended the University of Mississippi's nurse midwife program. Upon her graduation in May 1979, petitioner applied and was interviewed for several positions in health manpower shortage areas. Prior to being interviewed for these positions, petitioner sought and obtained authority from the Order to do so. One position petitioner applied for was a position with Su Clinica Familiar (the clinic). The clinic conducts a family health services program in Raymondville, Texas.

During the year in issue, a portion of the clinic's staff was employed through the National Health Services Corps (NHSC). The NHSC is a Federal program within the U.S. Public Health Service that assigns health professionals in its employ to deliver health care services in health manpower shortage areas. The NHSC provided the clinic with necessary professional staff, such as physicians, mid-level practitioners, and nurse-midwives. The professionals provided by the NHSC were employed and compensated by the Federal Government, and not by the clinic.

Although the details are not entirely clear, the record reveals that petitioner filed an application for employment with the NHSC in conjunction with her application to the clinic. Her application was made on a Federal Government Standard Form 171 on which she stated that she would not accept a salary of less than $16,000 per year. She applied for the job "in order to fulfill my 12-month commitment to practice as a Nurse Practitioner in a primary care health shortage area designated under Section 822(b) of the * * * [Public Health Services] Act." She stated on her application to the NHSC that she would accept a position only if she were assigned to work at the clinic in Raymondville, Texas. Subsequently, petitioner was interviewed over the telephone by an employee of the NHSC. Neither the NHSC nor the clinic is affiliated with petitioner's Order in any way.

The NHSC paid for petitioner to travel to the clinic in late May, 1979, "for the purpose of visiting the community as a prospective National Health Service Corps assignee." On June 27, the Clinic informed the NHSC of "the clinic's intention of employing Sister Francine Schuster as a staff nurse-midwife. She will begin on July 23, 1979."

After petitioner was informed that a position was available to her at the clinic, she requested permission from her Order to accept. Her Order determined that the position at the clinic would further the purposes of the Order by helping to relieve the suffering of humankind, and by promoting life, and thus informed petitioner that her mission was acceptable.

On July 1, 1979, the Acting Provincial Administrator of petitioner's Order addressed a letter to the director of the nurse-midwifery service at the clinic. That letter stated the following:

> Sister Francine Schuster [petitioner] had informed us of your recent phone notification of a current job opening in nurse midwifery at Su Clinica Familiar, Raymondville-Harlingen, Texas.
>
> The Community of Adorers of the Blood of Christ [the Order] would like to contract with you for the services of Sister Francine Schuster, ASC for the position of nurse-midwife for one year at Su Clinica Familiar.
>
> If our offer is acceptable, we request that payment for her services be made to the Adorers of the Blood of Christ.

Also on July 1, petitioner addressed a letter to the NHSC which "confirms that I have agreed to an NHSC assignment at * * * [the clinic]. My starting date will be 7/29/79." In addition, the Acting Provincial Administrator of petitioner's Order addressed a letter to the NHSC in which she stated the following:

> Sister Francine Schuster has informed us of your recent phone notification of a current job opening in nurse midwifery at Su Clinica Familiar, Raymondville - Harlingen, Texas.
>
> The Community of Adorers of the Blood of Christ would like to contract with you for the services of Sister Francine Schuster, ASC for the position of nurse-midwife for one year at Su Clinica Familiar.
>
> If our offer is acceptable, we request that payment for her services be made to the Adorers of the Blood of Christ.

In addition, the Order informed the NHSC that:

petitioner is a member in good standing of [the Order] * * * and is, therefore * * * under a vow of poverty; * * * her services are performed as part of the duties required to be performed by the member for/or on behalf of the order as its agent; and that all salaries or grants received by her accrue to the * * * [Order] because of her vow of poverty.

In response to the letter that the Order addressed to the clinic, the director of the nurse-midwifery service at the clinic sent a letter dated July 9, 1979, to the Acting Provincial Administrator of the Order which provided as follows:

Consider this letter as formal acceptance of Sister Francine Schuster on our nurse-midwifery staff. She will be beginning on the pay period that starts July 23. Sister Francine's checks will be paid to her and she can endorse them and send them to you. I endorse my checks "paid to the order of the Sisters of St. Mary. Sister Angela Murdaugh." There is no problem with them going through the mail like that.

The record contains no evidence that the NHSC ever responded to the Order's letter. Contrary to the Order's request, petitioner's paychecks were issued only in her name.

Petitioner began to work at the clinic on July 25, 1979, even though her NHSC appointment was not effective until July 29. As a result, the clinic paid petitioner for July 25, 26, and 27, and terminated payments effective July 27.

Petitioner's appointment by the NHSC was effective as of July 29, 1979. She was employed at the GS-9 level as an "excepted appointment" pursuant to normal Federal Government personnel policies. As a GS-9 employee, her salary was $15,920 per year. She accumulated annual leave and sick leave, and she qualified for Federal Health benefits. During the course of her appointment, petitioner received a within-grade increase in salary, and a salary increase for Federal employees made pursuant to Executive order. While employed by the NHSC, petitioner was entitled to, and received, continuing professional education classes paid for by the Federal Government.

On the effective date of her NHSC employment, petitioner signed a standard Government Form 61, on which she swore to support and defend the U.S. Constitution, and promised that she would not participate in any strike against the U.S. Government while employed by it or "any agency thereof."

As a member of the NHSC, petitioner was a civil service employee subject to the Department of Health, Education, and

Welfare standards of conduct. NHSC assignees are evaluated on a yearly basis through an employee performance appraisal system. Petitioner's performance as a midwife was evaluated on forms provided by the Federal Government.

The clinic and NHSC signed an agreement effective February 15, 1980, which provided that:

> The Assignee(s) [petitioner] shall remain at all times under the direct supervision and control of the DHEW [Department of Health, Education & Welfare] Regional Health Administrator or his designee. Observance of institutional rules and regulations by Assignee(s) are mere incidents of the performance of their Federal functions and do not alter their direct professional responsibility to the Secretary. * * * Day to day administrative direction will be given by the Project Director [an employee of the clinic].

The clinic, NHSC, and petitioner operated in accordance with this agreement.

The NHSC, pursuant to section 224 of the Public Service Health Act (42 U.S.C. sec. 223) provides all assignees with defense against all malpractice suits resulting from injuries occurring during the course of the assignee's employment.

While employed by the NHSC, petitioner was paid from the U.S. Treasury. Petitioner's wages were paid directly to her. Neither the clinic nor the NHSC imposed any restriction on petitioner's use of payroll checks. Petitioner endorsed to her Order each check tendered to her, and she sent each check to a lockbox maintained by the Order in St. Louis.

The Order did not provide the NHSC or the clinic with a replacement when petitioner used sick leave.

Petitioner terminated her association with the clinic in 1982, when the Federal funding for her position was terminated. Upon her separation from NHSC, petitioner was paid for 128 hours of accrued annual leave.

On petitioner's 1980 Federal income tax return, petitioner reported that she had received $18,771.20 in wages, but that the compensation was not subject to taxation "by reason of taxpayer being agent of religious order pursuant to Rev. Rul. 77-290." Respondent issued a notice of deficiency in which he determined that petitioner's wages were taxable because she was not working as an agent of a religious order when she earned her wages.

OPINION

At issue is whether petitioner's wages were paid to her in her individual capacity or as an agent for the Order. If the wages were paid to satisfy an obligation to pay petitioner individually, they are subject to taxation regardless of their ultimate transferral to the Order. E.g. *Lucas v. Earl*, 281 U.S. 111 (1930). If, on the other hand, the checks were delivered to petitioner in order to satisfy a debt owed to the Order, then petitioner received the checks as a mere agent of her Order, and is not subject to taxation individually. *Maryland Casualty Co. v. United States*, 251 U.S. 342 (1920).

Petitioner applied for employment as a Federal civil servant, and accepted a job as a National Health Service Corps employee. The NHSC assigned her to work at Su Clinica Familiar. Neither the NHSC nor the clinic is affiliated with or related to petitioner's Order in any way.

Petitioner filed a Standard Form 171 with the Federal Government on which she stated that she would not accept a salary of less than $16,000 per year. She stated that she had applied for the job "in order to fulfill my 12-month commitment to practice as a Nurse Practitioner in a primary care health shortage area" pursuant to Federal law, in exchange for having received Federal assistance to pay for her nursing education.

Petitioner was employed by the Federal agency pursuant to normal personnel policies. She accumulated annual leave and sick leave, and she qualified for Federal health benefits. She received all the benefits of a Federal employee employed at the GS-9 level, including a within-grade increase in salary, and a salary increase for Federal employees made pursuant to Executive order.

Petitioner received paychecks in her own name, and, pursuant to her private vows with the Church, endorsed her checks over to her Order. She personally handled all aspects of her relationship with the clinic and with the Federal Government; indeed, the only contact that those two institutions appear to have had with her Order occurred when the Order sent them letters stating that the Order wished to contract with them for petitioner's services, and that it would like her wages to be issued payable directly to the Order. The Federal Government ignored the letter, and issued checks made payable to petition-

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er. The clinic responded with a letter informing the Order that the checks would be made payable to petitioner, and that petitioner could endorse them over to the Order. These facts are clearly insufficient to support a finding that petitioner's paychecks were issued to satisfy an express or implied legal obligation to her Order, and we therefore hold for respondent.

The instant case is unlike many of the so-called "vow of poverty" cases decided recently by this Court[1] in that Sister Francine Schuster at all times acted strictly in accordance with her vows of poverty and obedience, and at no time after endorsing the checks did she exercise any sort of control over the funds. Petitioner is part of a long tradition that is respected in our society, and these private arrangements with her Order arise from deeply held convictions. The fact that we feel her life is a sincere and worthwhile example should not, however, alter the tax results. In the final analysis, apart from petitioner's vow of poverty arising from her personal religious convictions and way of life, this case is not different from any other assignment of income case.

The hornbook law on assignment of income was set out by Justice Holmes in *Lucas v. Earl*, 281 U.S. 111 (1930), when he stated:

> But this case is not to be decided by attenuated subtleties. It turns on the import and reasonable construction of the taxing act. There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew. [281 U.S. at 114–115.]

During the last half century since *Lucas v. Earl*, we have been advised repeatedly of the fundamental rule that income must be taxed to him who earns it; indeed, the Supreme Court has referred to the rule as "the first principle of income taxation." *Commissioner v. Culbertson*, 337 U.S. 733, 739 (1949); *United States v. Basye*, 410 U.S. 441 (1973). See Lyon &

[1] E.g., *McGahen v. Commissioner*, 76 T.C. 468 (1981), affd. without published opinion 720 F.2d 664 (3d Cir. 1983); *Ford v. Commissioner*, T.C. Memo. 1984–501; *Brennan v. Commissioner*, T.C. Memo. 1984–500; *Wert v. Commissioner* T.C. Memo. 1984–499.

Eustice, "Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case," 17 Tax L. Rev. 295 (1962).

Petitioner urges that this "first principle of taxation" does not apply because she received the paychecks merely as an agent of the Order, and cites to *Maryland Casualty Co. v. United States*, 251 U.S. 342 (1920). In that case, the Supreme Court held that paying insurance premiums to an insurance agent is equivalent to paying the insurance company directly, and that the insurance company must therefore take into its gross income those premiums held by its agents.

Petitioner asserts that her case falls within this rule because she agreed with her Order that she would act on its behalf and subject to its control, and because she subsequently remitted all the funds generated by her work to her Order. She states that "Only two parties are required to create the relationship."

What petitioner has failed to recognize is that, in the legal sense, one can perform services for a third party on someone's "behalf" only if some sort of obligation to perform the services rests initially with the person on whose behalf one wishes to act. If the "principal" is under no duty to perform the services itself, or to ensure that the services be performed, but merely approves of the performance as an irrelevant bystander, then, in the legal sense of the word, one cannot act on the other's "behalf." To this extent, the participation of three parties is required to create an agency relationship.

This analysis implicitly underlies the Supreme Court's decision in *Maryland Casualty Co. v. United States, supra*. In that case, the agent did not escape taxation because he was obliged to transmit the funds to his principal, nor did he escape taxation because his principal approved of his conduct. Rather, the Supreme Court reached its conclusion because "payment of the premium to the agent discharged the obligation of the insured and called into effect the obligation of the insurer as fully as payment to the treasurer of the claimant could have done." *Maryland Casualty Co. v. United States, supra* at 347. The premiums were the consideration for the risk underwritten by the insurance company, and payment to the agent was made to satisfy the obligation to pay the insurer. It was for this reason that the Court held that the principal, and not the agent, should be taxed.

Thus, the notion established in *Maryland Casualty Co.*, that an agent should not be taxed on amounts it receives as its principal's legal representative, depends upon the existence of some form of legal relationship between the principal and a third party. This Court and other courts have consistently required such a relationship. E.g. *Johnson v. United States*, 698 F.2d 372 (9th Cir. 1982); *Johnson v. Commissioner*, 78 T.C. 882, 891 (1982), affd. without published opinion 734 F.2d 20 (9th Cir. 1984); *Pacella v. Commissioner*, 78 T.C. 604, 619 (1982); *Keller v. Commissioner*, 77 T.C. 1014, 1027 (1981), affd. 723 F.2d 58 (10th Cir. 1983). In *Johnson v. Commissioner*, *supra* at 891, we stated that "there must exist between the corporation [the 'principal'] and the person or entity using the services a contract or similar indicium recognizing the corporation's controlling position."

The issue, then, is not whether the Order and petitioner agreed between themselves that petitioner would act as the Order's "agent." Rather, the issue is whether petitioner performed her services as an employee of the Federal Government, or whether the Federal Government contracted to receive the services from the Order, with petitioner performing the services as an agent of the Order. The facts in this case show that petitioner acted to affect only her own legal relationship with the Federal agency.[2] She expressly accepted the employment in order to satisfy her personal obligation to work in a health manpower shortage area. If her rights as a Federal employee had been violated, petitioner could have brought suit only in her individual capacity, and the Order could have become involved, if at all, only as an assignee of petitioner's contract rights.

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[2]Indeed, the U.S. Claims Court recently reached the same conclusion in a very similar case. *Fogarty v. United States*, 6 Cl. Ct. 612 (1984), on appeal (Fed. Cir., Jan. 16, 1985). *Fogarty* involved a Roman Catholic priest who worked as an associate professor at the University of Virginia's Department of Religious Studies. The court found that teaching is an essential and traditional religious mission of the priest's religious order, that the priest had accepted the position upon instruction from his superior, and that he had acted strictly in accordance with his vow of poverty at all relevant times. The Claims Court nevertheless determined that the wages paid were taxable to the priest, stating as follows:

"if the income generated from plaintiff's employment is to be treated as that of the Order, it must first be established that the contract under which the income was earned was that of the Order. * * * Simply put, the question is to whom did the third party look for the accomplishment of the services it bargained for—to the plaintiff or to his Order?"

The court based its conclusion that the university looked directly to the priest for performance on facts indistinguishable from those involved in the instant case.

It was the Federal Government, and not the Order, who assumed responsibility for any malpractice liability petitioner might incur, and thus it seems clear that both parties assumed that the Federal Government as employer, rather than petitioner's Order, would have been held responsible under the doctrine of respondeat superior if petitioner had injured someone during the course of her employment. It was petitioner, and not the Order, whom the Federal Government advised that "the NHSC professional is required to place official responsibilities above any conflicting interests or associations. He/she must avoid conflicts of private interests with public duties and responsibilities," and petitioner was bound in her individual capacity by this requirement. If petitioner had violated her vows with the Church by retaining the checks for her personal use, her Order would have had no legal claim against the clinic or the Federal Government, and petitioner's relationship with her employers would have been unaffected.

In determining whether earnings from personal services are taxed to an individual or to an affiliated corporation, courts have examined two factors. First, as discussed above, courts have looked for some indicium of an agreement between the corporation and third parties. Second, they have required that the service-performer employee "be just that—an employee of the corporation whom the corporation has the right to direct or control in some meaningful sense." *Johnson v. Commissioner, supra* at 891; see *Vnuk v. Commissioner*, 621 F.2d 1318, 1320–1321 (8th Cir. 1980), affg. a Memorandum Opinion of this Court; *Vercio v. Commissioner*, 73 T.C. 1246–1255 (1980).

Although the entity here is a religious order, no different criteria should apply, and clearly the Order does not control the earning of the income as that term has been used in the decided cases.

Facing similar facts and an analogous legal issue, the U.S. Claims Court recently held that wages received by a Catholic nun as an employee of a county hospital were subject to the FICA tax. *Samson v. United States*, 4 Cl. Ct. 325 (1984), affd. 743 F.2d 884 (Fed. Cir. 1984). The plaintiff in that case argued that, as a member of a religious order who was subject to vows of poverty and obedience, she was "directed or required" by her superiors to perform services at the hospital in pursuit of the mission of her Order. This argument is analogous to petition-

er's argument in the instant case that her Order controlled the earning of the income. The following response by the Claims Court applies equally here:

> The plaintiff's argument is superficially appealing until it is realized that, from the standpoint of reality, the Order could not *require* or *direct* the plaintiff to perform the duties of the civil service position of Speech Therapist, job classification No. 1390, for the St. Louis County Department of Community Health and Medical Care. Actually, the Order did not have any authority or responsibility in connection with the selection of the person who was to fill and perform the duties of that position. Standing alone, a purported requirement or directive by the Order that the plaintiff take over and perform the duties of the civil service Speech Therapist position with the St. Louis County Department of Community Health and Medical Care would have been absolutely meaningless.
>
> The authority and responsibility with respect to determining who would fill and perform the duties of the Speech Therapist position were vested in an appointing official of the St. Louis County Department of Community Health and Medical Care, acting on the recommendations of other county officials and in accordance with the regulations of the St. Louis County Civil Service Commission. The extent of the Order's participation in the matter was merely to determine whether the plaintiff should apply and compete for the position and, later, to determine whether the plaintiff should accept the position when it was offered to her by the appointing official of the county, after her application had been considered and she had undergone successful interviews with county officials.
>
> In essence, the Order's role was to grant (or deny) authorizations to the plaintiff with respect to her desire to participate in the county's appointing process. The Order could not—and did not—issue any mandatory requirement or directive controlling the appointing process.
>
> [*Samson v. United States*, 4 Cl. Ct. at 329.]

It is one thing for a member of a religious order to work in the schools, hospitals, and other facilities of the Order. It is an entirely different matter for a member of that Order to enter the secular world as an employee of the Federal Government, or of a private corporation. In the former case, the individual deals with third parties (for example, students and patients) on behalf of the Order, as the Order's legal representative and subject to the Order's daily control over whether, and how, the services are performed. Third parties have chosen to form a relationship with the Order, and the individual represents the Order in the relationship. Whatever amounts are paid by these third parties are paid to satisfy a legal obligation to the Order. In the latter case, the Federal Government or corporation pays the individual in satisfaction of its legal obligation to her as an

employee. The Order is not involved at all, except as the recipient of petitioner's earnings when she endorses her check over to the Order.

We therefore conclude that petitioner earned the income at issue in her individual capacity, and is properly subject to taxation upon it. *Lucas v. Earl*, 281 U.S. 111 (1930).

Decision will be entered for the respondent.

Reviewed by the Court.

DAWSON, SIMPSON, STERRETT, CHABOT, PARKER, HAMBLEN, COHEN, CLAPP, JACOBS, and WRIGHT, *JJ.*, agree with the majority opinion.

GERBER, *J.*, did not paricipate in the consideration of this case.

KÖRNER, *J.*, I must respectfully dissent from the majority opinion in this case.

The majority seems to be overwhelmed by the fact that petitioner was carried on the rolls as a Federal Government employee, was paid by a Federal Government check, and had all the protections and benefits that other Federal employees get, e.g., paid sick leave and vacations, retirement benefits and the like, all of which the majority discusses in great detail. Under the apparent spell of these conceded facts, the majority then only feels it necessary to invoke *Lucas v. Earl*, 281 U.S. 111 (1930), and that is the end of the matter: respondent prevails.

Why this relationship to the Federal Government is so important to the majority in deciding the case escapes me. Presumably, petitioner would have had some or comparable benefits if she had been employed in private industry. Is the majority intimating that there would be a different result in such case? I do not see how this could be so. To me, it is entirely unimportant whether petitioner is to be considered an employee of the Federal Government or an employee of the clinic, which supervised and directed her day-to-day work and was the place where she was employed. It is not even in dispute in this case that petitioner worked for an employer

outside her own Order; both sides agree that it is so. The real question in the case is this: when compensation was paid to petitioner for her services at the clinic, did petitioner receive that paycheck under her own claim of right as a person who had independently contracted her services, or did petitioner receive such paycheck as the agent of the Order, under a preexisting and enforceable contract obligation to serve as such agent? In my opinion, the latter is the correct answer, and requires that the case be decided in favor of petitioner.

Section 61 provides the general rule that gross income includes all income, from whatever source derived, except as otherwise provided by law. Section 61(a)(1) specifically includes compensation for services within the definition of gross income. Moreover, it is a fundamental rule of Federal tax law that attempts by a taxpayer to shift the incidence of taxation, by anticipatorily assigning income earned in his individual capacity, will be ineffectual. See sec. 1.62–2(c), Income Tax Regs. This basic rule derives from *Lucas v. Earl*, *supra*, where the Supreme Court said:

> There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute [sec. 61] before us * * * [281 U.S. at 114–115.]

The frequently referenced "first principle of income taxation: That income must be taxed to him who earns it," *Commissioner v. Culbertson*, 337 U.S. 733, 739–740 (1949), finds its genesis in the above quote from *Lucas v. Earl*, *supra*, and is the bedrock of the majority's position in this case.

However, almost from the announcement of the assignment of income doctrine in *Lucas v. Earl*, *supra*, the Supreme Court acknowledged that practical realities dictate against an overly simplistic application of the rule which would always allow identification of the taxable party merely by pointing to the individual whose efforts generated the payments in question. Recognition must be given to the fact that, because of various fiduciary, business, and other legal relationships and restrictions encountered in the real world, an individual's personal labors may generate income which, although passing through his hands, never in fact becomes property subject to his actual

control or disposition. Such recognition militates against carrying the "first principle of taxation" to a dryly logical extreme. Thus, in *Poe v. Seaborn*, 282 U.S. 101 (1930), decided only 8 months after *Lucas v. Earl*, *supra*, the Supreme Court held that the earnings of couples living in community property States must be reported one-half by each, irrespective of the fact that one spouse's personal efforts generated all of the income of the marital community. The Court reasoned that, in a community property State, the husband was the *agent* of the marital community, and "the earnings [of the husband] are never the property of the husband, but that of the [marital] community." *Poe v. Seaborn*, *supra* at 117.

For similar reasons, it has long been the rule that where an agent, within the scope of his agency, earns income on behalf of a separate and distinct principal and, in accordance with his fiduciary duty, turns such income over to his principal, it is the income of the principal and not the agent. *Maryland Casualty Co. v. United States*, 251 U.S. 342 (1920). This basic rule recognizes that, under the law of agency, an agent who labors within the scope of his agency, and thereby generates income, is, by law, duty-bound to transmit such income to the principal. 2 Restatement, Agency 2d, sec. 388 (1957) (hereinafter cited as "Restatement Agency"). The assignment of income doctrine of *Lucas v. Earl*, *supra*, simply has no application in such a case, since the agent never receives or contemplates receiving income which he is in a position to assign in his own right.[1]

The issue presented in this case—whether petitioner is taxable upon income paid with respect to her services as a midwife—therefore requires a determination of whether the income was earned by petitioner in her individual capacity, or in her capacity as an agent of the Order. If the income was earned by petitioner in her individual capacity, her transfer of such income to the Order will not relieve her of tax liability thereon. *Lucas v. Earl*, *supra*; sec. 1.61–2(c), Income Tax Regs. If, on the other hand, petitioner earned such income only in her capacity as agent for the Order, it is income to the Order and not to petitioner. Cf. *McGahen v. Commissioner*, 76 T.C. 468, 478–479 (1981), affd. 720 F.2d 664 (3d Cir. 1983).

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[1] See 2 J. Mertens, Law of Federal Income Taxation, sec. 17.11 (1982 rev.).

In resolving this question, we must bear in mind that in cases such as this, where a taxpayer alleges that income generated by his personal labor was earned not on his own behalf but on behalf of a third party, the "choice of the proper taxpayer revolves around the question of which person or entity * * * controls the earning of the income rather than the question of who ultimately receives the income." *Vercio v. Commissioner*, 73 T.C. 1246, 1253 (1980); *Vnuk v. Commissioner*, 621 F.2d 1318, 1320 (8th Cir. 1980), affg. a Memorandum Opinion of this Court; *Johnson v. United States*, 698 F.2d 372, 374 (9th Cir. 1982); *Johnson v. Commissioner*, 78 T.C. 882, 891, (1982), affd. without published opinion 734 F.2d 20 (9th Cir. 1983), cert. denied 469 U.S. ____ (1984); *Pacella v. Commissioner*, 78 T.C. 604, 622 (1982).

After reviewing all of the facts in this case, I would hold that: (1) Upon her admission to the Order, petitioner, by enforceable agreement, became an agent of the Order, a separate and distinct principal, for purposes of furthering the expressed goals of the Order; (2) petitioner's acceptance and conduct of her duties at the clinic was within the scope of her agency relationship; (3) because of the nature of petitioner's agency relationship with the Order, as well as her relationship with the clinic and NHSC, the Order, and not petitioner, in every real sense, controlled the earning of the income at issue; (4) accordingly, the income at issue is not properly taxable to petitioner.

An agency relationship is defined as "the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act." Restatement Agency, sec. 1(1). Generally, the scope of an agent's authority to act "can be created by written or spoken words or other conduct which, reasonably interpreted, causes the agent to believe that the principal desires him so to act on the principal's account." Restatement Agency, sec. 26. Whether the requisite consent and control for the creation of an agency relationship are present in any given case must be resolved by an examination of all the facts and circumstances. Restatement Agency, sec. 15.

The facts in this case reveal that, as a precondition to her admission to the Order, petitioner was required to undertake a vow of obedience whereby petitioner, inter alia, agreed to:

> embrace the Father's will as it is expressed in the constitution [of the Order] and as it is mediated through those who exercise authority in our congregation.

The purposes of the Order, as expressed in its articles, included, inter alia:

> to conduct hospitals and institutions for the care and treatment of suffering humanity and to do all and everything necessary or convenient for the accomplishment of any purposes or objects and powers above mentioned or incidental thereto.

In addition to expressly agreeing to act under the direction of the Order in furtherance of the purposes of the Order, and as a further precondition to her admission to the Order, petitioner agreed that she would give over to the Order everything she earned in pursuit of the purposes of the Order, and accept from the Order only that which is necessary to satisfy her basic needs. As a corollary to her vow of poverty, petitioner agreed never to claim or demand, directly or indirectly, any wages, compensation, or other remuneration for services she performed in furtherance of the purposes of the Order. The majority correctly so finds.

Having satisfied these requisites, petitioner was admitted to the Order, and having been admitted, petitioner's vows of obedience and poverty became valid and enforceable contract obligations. *Order of St. Benedict of New Jersey v. Steinhauser*, 234 U.S. 640 (1914).

Taken together, the admission of petitioner into the Order and the agreements of petitioner outlined above, manifest the consent of the Order that petitioner act on its behalf, subject to its direction and control, in furtherance of the purposes of the Order, as well as petitioner's consent to so act, on the Order's account, and for its benefit. A principal-agent relationship between the Order and petitioner was therefore, by definition, created upon petitioner's admission to the Order. Restatement Agency, sec. 1.

It is clear on this record that the agency relationship, thus created in form, was abided by in practice and substance by

both petitioner and the Order with respect to petitioner's employment at the clinic. The Provincial Superior, in conjunction with the placement board of the Order, is vested with sole authority to approve or disapprove a proposed mission. Pursuant to her vow of obedience, petitioner could neither apply for nor accept a position of employment without express approval of and direction by the Order, and such approval would be granted by the Order only upon its determination that the proposed mission work would further the purposes of the Order. In accordance with these requirements, prior to interviewing for the position with the clinic, petitioner sought permission from the Order to do so, and, after the Order determined that the nature of the employment at the clinic would be in keeping with the goals of the Order, such permission was granted.

After petitioner was interviewed for a position at the clinic and was informed that a position was available to her, she relayed this information to her superiors at the Order and requested permission to accept the position. The Order then contacted the clinic and offered to contract with the clinic for the services of petitioner. As set out in our findings, the clinic, by letter to the Order, formally accepted petitioner on their nurse-midwifery staff, and was fully aware of petitioner's relationship with the Order. Moreover, when petitioner applied for the position with NHSC so that NHSC, rather than the clinic, would assume financial responsibility for petitioner's services, petitioner specifically stated in her application that she would accept an offer with NHSC only if she would be assigned to perform services at the clinic. Petitioner's personnel folder from NHSC contains a letter from the Order dated June 26, 1979, calling attention to the fact that petitioner was a member of the Order and that her services would be performed for NHSC "on behalf of the Order as its agent." Moreover, petitioner's personnel folder contains another letter from the Acting Provincial Administrator of the Order, to the Department of Health and Human Services, wherein the Order proposed to contract with NHSC for petitioner's services. Although no formal contract was entered into between the Order and NHSC for petitioner's services, it is nevertheless clear that NHSC was fully informed of petitioner's relationship with the Order, and that it did not object to her status.

Petitioner's agency status was thus explicitly disclosed by the Order and accepted by the clinic, and implicitly accepted by NHSC.

Although petitioner's day-to-day activities as a midwife were directed by her supervisors at the clinic, petitioner nevertheless remained subject to the ultimate control of the Order during her tenure there. The Order conducted an annual review of each mission to determine whether it was in conformity with the purposes of the Order, and from time to time visited each Sister at the mission site to verify the mission, in practice, furthered the objectives of the Order. Moreover, if at any time the Order determined that petitioner's mission failed to conform to the objectives of the Order, the Order possessed authority to require petitioner to withdraw from the mission, and petitioner, pursuant to her vow of obedience, was under a duty to follow any such command, and would have done so. It is clear that at all times during her employment at the clinic, petitioner remained under the ultimate control of the Order.

It is also clear that petitioner's work at the clinic was within the scope of the agency relationship. As indicated *supra*, one of the purposes of the Order was to provide medical care for those in need. Clearly petitioner's services as a midwife at a health clinic which provides services to the poor further such purposes.

Finally, all proceeds generated by petitioner's work at the clinic on the Order's behalf, pursuant to petitioner's obligation, were paid over to the Order. The Order provided petitioner with only the minimum basic necessities of life that all Sisters of the Order received, and there was a complete absence of any device whereby petitioner derived any benefit, directly or indirectly, through a rebate determined by reference to her salary.

On these facts, I would hold that the income generated by petitioner's services as a midwife was earned by her as an agent of the Order, and not in her individual capacity.

The primary theory respondent advances, and which the majority regrettably embraces, is styled by respondent as a "triangle theory." Under this theory, where, as here, an individual's personal labors generate income, a finding that such income was earned on behalf of a separate and distinct

principal is preconditioned upon a subsidiary finding that a contract or other express agreement existed between the payor of the income and the alleged principal, wherein the alleged principal expressly grants the payor the right to use the individual's services on the principal's behalf. It is not enough, the majority holds, that a relationship exist solely between petitioner and her Order; in addition, they say, NHSC must have expressly contracted with the Order for petitioner's services before the Order is to be considered the true earner of income. Otherwise, it is said, petitioner may properly be viewed only as an "employee" of NHSC, and such status is inconsistent with the proposition that the income at issue was earned by petitioner as an agent for the Order. This is the broad position asserted by respondent in a recent revenue ruling. See Rev. Rul. 83–127, 1983–2 C.B. 25. The majority primarily relies upon *Johnson v. United States*, *supra*, and *Johnson v. Commissioner*, *supra*, as support for its conclusion that an express contract for petitioner's services between the Order and NHSC is an absolute prerequisite to a finding that petitioner was acting as an agent of the Order in rendering services to the clinic.

The "triangle" theory applied here is premised upon an inaccurate appraisal of the law of agency as well as the facts of this case.

First, as discussed above, an agency relationship is, by definition, created when one individual or entity grants consent to another that the other shall act on his or its behalf, and the other consents to so act. Restatement Agency, sec. 1. Thus, only two parties are required to create an agency relationship. The majority—erroneously, in my opinion—rejects this proposition.

Second, it is equally clear that an individual may simultaneously act as an agent for two principals with respect to the same activities so long as the services rendered on behalf of one principal do not constitute an abandonment of the relation with the other. Restatement Agency, sec. 226. Thus, contrary to the clear implications of the majority opinion, even if petitioner qualified as an "employee" (which is merely one type of agent) of NHSC under technical agency rules, see Restatement Agency, sec. 2, such status is not inconsistent with a finding that the income earned in that capacity was

earned on behalf of and as an agent for the Order, so long as her assumption of her position at the clinic did not constitute an abandonment of her relation with the Order.[2]

Petitioner, in assuming the position at the clinic, did not in any manner abandon her relationship with the Order. To the contrary, petitioner was authorized and directed by the Order to accept the position, remained subject to the ultimate direction and control of the Order at all times, and the position itself was in furtherance of the purposes of the Order. Moreover, although the Order did not expressly contract with NHSC for petitioner's services, petitioner's status as agent of the Order was expressly disclosed to NHSC, and implicitly accepted by it. Under these circumstances, petitioner's status as an "employee" (as that term is defined under general rules of agency law) of NHSC does not negate the fact that the income at issue was earned by her in her capacity as agent of the Order.

The majority's reliance on *Johnson v. United States*, *supra*, and *Johnson v. Commissioner*, *supra*, is misplaced. In these cases, the taxpayer, a professional basketball player, executed a contract with an unrelated corporation whereby he granted the corporation the right to his services in professional sports for a limited time in return for payment by the corporation of a monthly sum. During the years in issue, the taxpayer played for a professional basketball club with which he signed player contracts. However, the basketball club "adamantly refused" to recognize the corporation's controlling position over the taxpayer and expressly refused to sign any contract or agreement with the corporation for petitioner's services. *Johnson v. Commissioner*, 78 T.C. at 893. This Court and the Ninth Circuit Court of Appeals held that, under these circumstances, the basketball player, and not the corporation, was to be considered the true earner of the income generated by the basketball player's activities with the club, despite the fact that all such amounts were paid over to the corporation.

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[2] The majority lays great stress on the fact that petitioner was carried as an "employee" on the rolls of NHSC, which actually issued her pay checks. The facts show, however, that petitioner was actually employed at the clinic, with funds provided by NHSC. Except for its own bureaucratic reasons, it appears that NHSC could just as well have provided the funds to the clinic, which in turn could have issued its pay check to petitioner. It is clear that it was the clinic, a Catholic charity, which directed petitioner's day-to-day nursing activities, and not NHSC. Cf. Rev. Rul. 68-123, 1968-1 C.B. 35; Rev. Rul. 77-290, 1977-2 C.B. 26.

Johnson v. United States, *supra*, and *Johnson v. Commissioner*, *supra*, thus present a completely different situation than that presented here. The payor of the income in those cases expressly and "adamantly" refused to recognize the corporation's controlling status and the taxpayer nevertheless assumed a position with the basketball club. Under these circumstances it can reasonably be said that the taxpayer, by accepting a position with the basketball club, had abandoned his agency relationship with the corporation. In the present case, however, no such conclusion is warranted since petitioner's status as agent of the Order was disclosed and accepted by the clinic and NHSC. Although the presence of an executed contract between the Order and NHSC may have been advisable from a taxplanning viewpoint, in light of respondent's current ruling position, the absence of such a written contract is not fatal to petitioner's case. Indeed, we have held that the presence of such a contract is not an absolute prerequisite to a finding that income generated by an individual's efforts is earned on behalf of a separate and distinct entity. *Pacella v. Commissioner*, 78 T.C. at 618–619, 622.

In elevating the "triangle theory" into a rule of the law of agency, I think the majority goes too far. The most that can be said for it is that where the facts of a given case show that the outside employer has refused to deal with the prospective employee as the agent for another, but only in his individual capacity, the consummation of an employment agreement between the parties may fairly be viewed as an abandonment of the employee's prior ongoing relationship with his principal, or at least as an employment outside the scope of the agency. *Johnson v. United States*, *supra*; *Johnson v. Commissioner*, *supra*.[3] That was clearly not the case here.

The majority relies upon *Samson v. United States*, 4 Cl. Ct. 325 (1984), affd. 743 F.2d 884 (Fed. Cir. 1984). However, in *Samson*, the issue presented to the Court was whether services performed by a member of a religious order for a State governmental unit constituted "employment" within the intendment of the Federal Insurance Contributions Act (FICA),

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[3]We are not called upon here to consider the tax implications of an employment arrangement where an agent is working for an undisclosed principal. I note, however, that respondent's position in the present case appears to be at odds with his earlier published position in Rev. Rul. 58-515, 1958-2 C.B. 28, and see Restatement Agency, sec. 186.

not whether the income generated by the member's activities was properly taxable to her under section 61. I express no opinion on the correctness of the result reached in *Samson*. Suffice it to say, that the case is simply inapposite here. Whether income generated by an individual's activities is subject to FICA is an entirely separate question from whether the individual is properly subject to *income* tax thereon. Cf. *McGahen v. Commissioner*, *supra* at 480–481.[4]

The majority also relies on the recent case of *Fogarty v. United States*, 6 Cl. Ct. 612 (1984), on appeal (Fed. Cir., Jan. 16, 1985), in which a Roman Catholic priest, with the same essential relationship to his order as the petitioner has in this case, who accepted a teaching position with a secular university with the consent and direction of his order, and turned over all his salary to his order pursuant to his vows, was held to be personally taxable on such salary. I agree that the controlling facts in *Fogarty* are indistinguishable from the facts in the present case; with respect, I think that *Fogarty* is wrong.

In *Order of St. Benedict of New Jersey v. Steinhauser*, *supra*, the decedent, a member of a teaching order with vows of poverty, chastity, and obedience, had a distinguished career as an author of learned works and a teacher at various institutions during his lifetime. In these pursuits, he earned royalties and other emoluments which he failed to turn over to his order, as he was required to do. Upon his death, therefore, he left an estate of some value, a situation inconsistent with the vows he had professed to his order. Litigation then ensued between the decedent's administrator and the order, as to who was entitled to decedent's estate. The Supreme Court held that the vows made by decedent to his order were a condition to his admission to the order, and when he was admitted, a binding and enforceable contract was created between them. As the result, the order was held to be the true owner of the assets of decedent's estate.

Steinhauser, although not a tax case, is instructive. It teaches us that the relationship between petitioner here and her Order was founded in a mutual, valid, and enforceable

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[4] For similar reasons, I would reject the analysis adopted by respondent in Rev. Rul. 77-290, 1977-2 C.B. 26, wherein he relies upon secs. 3121(b)(8)(A) and 3401(a)(9) (defining "wages" for withholding purposes) and the regulations promulgated thereunder, in concluding that payments to a member of a religious order are *income* under sec. 61.

contract, and that she was the servant and agent of her Order. Had petitioner kept her paychecks for herself, I would have no difficulty in finding her taxable thereon, as having taken them under claim of right and converted them to her own use. *Kelley v. Commissioner*, 62 T.C. 131 (1974). On the other hand, the contract here between this petitioner and the Order was scrupulously observed by both sides. Petitioner clearly did not receive her paychecks under claim of right for herself, but only on behalf of, and as agent for, her Order, and she derived no personal benefit therefrom.

I do not think that *Lucas v. Earl* has overruled *Steinhauser*, nor has it repealed the law of agency as it applies to income tax cases. Petitioner at all times relevant, acting strictly in accordance with her vows, transmitted all funds generated by her labors to the Order. Petitioner did not have authority to exert dominion and control over the income at issue, and in fact, did not. The agency relationship created between petitioner and the Order was legal, binding, and was respected in substance.

I think that a blind and indiscriminating application of *Lucas v. Earl* to the facts of this case is neither required nor appropriate. I therefore conclude that the income at issue was received by petitioner in her capacity as agent of the Order; accordingly, she is not properly taxable thereon. *Maryland Casualty Co. v. United States*, *supra*.

FAY, GOFFE, NIMS, WHITAKER, SHIELDS, and SWIFT, *JJ.*, agree with this dissent.

ESTATE OF MARVIN F. PULLIN, DECEASED, BENHAM M. BLACK, EXECUTOR, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 18606–82. Filed May 1, 1985

At the time of his death, the decedent was a tenant in common with no right of survivorship in farm property with others who were not his heirs or devisees. Petitioner estate elected the

special use valuation of this farm property under the provisions of sec. 2032A, I.R.C. 1954, but the agreements required by sec. 2032A(d)(2), I.R.C. 1954, were not signed by the surviving tenants in common. *Held*: The surviving tenants in common had no interest in the "designated property" upon the death of decedent, and sec. 20.2032A–8(c)(2), Estate Tax Regs., is invalid by including as persons having an interest in the designated property all "co-tenants" insofar as that term includes surviving tenants in common. Accordingly, surviving tenants in common are not required to sign agreements prescribed by sec. 2032A(d)(2), I.R.C. 1954.

Benham M. Black, for the petitioner.
T. Keith Fogg and *Scott Anderson*, for the respondent.

OPINION

GOFFE, *Judge*: The Commissioner determined a deficiency in petitioner's Federal estate tax in the amount of $9,303.25. The sole issue for our decision[1] is whether the written agreement filed by an estate, in electing the special valuation of farm property as required by section 2032A(a)(1)(B)[2] and section 2032A(d)(2), must be executed not only by the beneficiaries of the decedent's estate but also by persons who were tenants in common with the decedent in such farm property but who did not receive, under the terms of decedent's will or otherwise, any interest in the property from the decedent.

This case was submitted fully stipulated pursuant to Rule 122 of the Tax Court Rules of Practice and Procedure. The stipulation of facts and joint exhibits are incorporated herein by this reference. The pertinent facts are summarized below.

Marvin F. Pullin (decedent or Mr. Pullin) died on August 3, 1978. He was survived by his daughter, Linda P. Napier, and two grandchildren, Daniel Allen Napier and Jana LaJoy Napier.

At the time of his death, decedent and his brother, Theodore Pullin (hereinafter Theodore), were tenants in common without the right of survivorship in 96.38 acres of farm property located in Augusta County, Virginia, known as the Morris Mill

[1] The parties have stipulated that petitioner is entitled to claim additional administrative expenses under sec. 2053. This stipulation will be given effect in the Rule 155 computation.

[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect at the time of the decedent's death, Aug. 3, 1978.

Road Farm. The undivided interests of decedent and Theodore were two-thirds and one-third, respectively. Theodore was not a beneficiary under decedent's will.

Decedent and his sister, Bertie P. Parsons (hereinafter Bertie), were, at the time of decedent's death, tenants in common without the right to survivorship in 139.64 acres of farm property also located in Augusta County, Virginia, known as the Frog Pond Farm. The undivided interests of decedent and his sister were one-half each. Bertie was not a beneficiary under decedent's will.

The decedent bequeathed an undivided one-third of his interest in all real estate to his daughter, Linda P. Napier, and the remainder to his grandchildren in equal shares (in trust if not having attained the age of 18 at the date of death of decedent). After decedent's death, the two-thirds interest was transferred to trustees of a trust for the benefit of decedent's two grandchildren.

Both of the farm properties constitute "qualified real property" under section 2032A(b) entitling petitioner to utilize the "special use valuation" provisions for estate tax purposes.

Petitioner timely filed an election for special use valuation of the farm property. Respondent agrees that the election is proper in all respects except for the failure of the surviving tenants in common to execute the agreement, which agreement is prescribed in section 2032A(d)(2) of the Code.

The sole question presented for our decision, therefore, is whether petitioner is entitled to value the farm property under the special use valuation provisions without including the signatures of the surviving tenants in common on the agreement prescribed by section 2032A(d)(2) of the Code.

In order to qualify for special use valuation, section 2032A(a)(1)(B) requires the following:

> (B) the executor elects the application of this section and files the agreement referred to in subsection (d)(2).

Section 2032A(d)(2), in turn, provides:

> (d) ELECTION; AGREEMENT.—
>
> * * * * * * *

(2) AGREEMENT.—The agreement referred to in this paragraph is a written agreement signed by each person in being who has an interest (whether or not in possession) in any property designated in such agreement consenting to the application of subsection (c) with respect to such property.

Section 20.2032A–8(c)(2), Estate Tax Regs.,[3] provides:

(2) *Persons having an interest in designated property. An interest in property is an interest which, as of the date of the decedent's death, can be asserted under applicable local law so as to affect the disposition of the specially valued property by the estate.* Any person in being at the death of the decedent who has any such interest in the property, whether present or future, or vested or contingent, must enter into the agreement. Included among such persons are owners of remainder and executory interests, the holders of general or special powers of appointment, beneficiaries of a gift over in default of exercise of any such power, *co-tenants*, joint tenants and *holders of other undivided interests when the decedent held only a joint or undivided interest in the property* or when only an undivided interest is specially valued, and trustees of trusts holding any interest in the property. An heir who has the power under local law to caveat (challenge) a will and thereby affect disposition of the property is not, however, considered to be a person with an interest in property under section 2032A solely by reason of that right. Likewise, creditors of an estate are not such persons solely by reason of their status as creditors. [Emphasis added.]

We must decide whether the surviving tenants in common had an interest in the farm property subject to the special use valuation. If they did, they were required by section 2032A(d)(2) of the Code, quoted above, to execute the agreement to consent to the application of section 2032A(c) of the Code.

Section 2032A(d)(2) refers only to property designated in the agreement. The only property designated in the agreement, indeed, the only property subject to estate tax, is the property owned by the decedent. He did not hold the entire interest in the property. His interest was only a two-thirds interest as tenant in common in the Morris Mill Road Farm and one-half interest as tenant in common in the Frog Pond Farm. Only the value of his interest is includable in the gross estate. Sec. 2033. The special use valuation provisions can apply only to his interest.

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[3] Although the regulations involved in this case were adopted after the death of decedent, they are applicable to estates of decedents who died after Dec. 31, 1976. T.D. 7710, 1980-2 C.B. 254.

The basis for gain or loss of property acquired from a decedent or passing from a decedent is, inter alia, the value determined for estate tax purposes under section 2032A. Sec. 1014(a)(3). The devisees under Mr. Pullin's will, upon distribution of the decedent's interests in the farm property, will have a basis for gain or loss equal to the value we ultimately determine for Mr. Pullin's interest for estate tax purposes. Sec. 1014(a).

The bases for gain or loss of the interests of Theodore and Bertie in the farm property as surviving tenants in common remain unchanged as a result of the death of Mr. Pullin. Neither individual incurred any liability for estate tax as a result of the death of their co-tenant, nor do they get a stepped-up basis for their interests.

The special use valuation provisions apply only to the value of "qualified real property." Sec. 2032A(a)(1). "Qualified real property" is defined as real property located in the United States which was acquired from a decedent or passed from a decedent to a qualified heir. The only "qualified real property" for which the estate elected special use valuation was Mr. Pullin's tenancies in common in the farm property. The entire fee simple in the farm property cannot be "qualified real property" because only the *decedent's* tenancies in common pass from the decedent to qualified heirs. The tenancies in common owned by decedent's brother and sister who survived him were owned by them prior to Mr. Pullin's death and those interests remained unchanged and unaffected by the death of Mr. Pullin. Those interests were not acquired from Mr. Pullin nor did they pass from Mr. Pullin to his brother or sister, the surviving tenants in common. Moreover, the surviving tenants in common are not "qualified heirs" under section 2032A(e) not only because they did not acquire their interest from the decedent [section 2032A(e)(1)] but also because they are not "heirs" under Virginia law. They received nothing under the will of Mr. Pullin and they received nothing from his estate. Even if Mr. Pullin died intestate they would not be heirs at law because Mr. Pullin was survived by a daughter. Va. Code Ann. sec. 64.1-1 (Supp. 1979).

We, therefore, construe section 2032A(d)(2) of the Code to be as follows: "property designated in such agreement" means the interest that the decedent owned which is subject to the

estate tax and the special use valuation. Because the surviving tenants in common had no interest in the "designated property" they were not required to execute the agreement by reason of the language of section 2032A(d)(2) of the Code.

We next turn to section 20.2032A–8(c)(2), Estate Tax Regs., (quoted above) to decide whether the surviving tenants in common are described there. The first sentence reads as follows:

> An interest in property is an interest which, as of the date of the decedent's death, can be asserted under applicable local law so as to affect the disposition of the specially valued property of the estate.

In keeping with our interpretation of section 2032A(d)(2) of the Code above, we likewise hold that the specially valued property consists of the decedent's tenancies in common in the farm property. This sentence of the regulations buttresses our conclusion reached above because it refers to disposition *of the property* by the estate. The estate can only dispose of the decedent's tenancies in common because the estate owns nothing more.

The rights of a tenant in common to convey his rights by deed or will are best described in Michie's Jurisprudence of Virginia and West Virginia (1976 & Supp. 1984), the most widely accepted treatise on the subject (hereinafter cited as M.J.).

> Sec. 12. *Conveyance by One of Common Property.* A tenant in common has the power to convey his undivided interest, and a deed from a tenant in common carries to the grantee only an undivided interest in the property, no matter by what description the property is conveyed. Thus, where the title to the land held in common is conveyed to one of the joint owners and he, reciting that he owns the whole, conveys one half of it to a third person and purports to convey the upper moiety, it will be held that the deed passes only an equal undivided moiety of the common subject, and that the other joint owner and the grantee hold in common the whole subject and every part thereof. In short, persons deriving title from one cotenant will be regarded as tenants in common with the other cotenant.
>
> Where a cotenant conveys his undivided interest in the lands held in common without the knowledge or consent of his companions in interest, the grantee in the deed is a tenant in common in the land with all the rights and obligations of his grantor with reference thereto.
>
> [5A M.J., Cotenancy, sec. 12. Fn. ref. omitted.]

"The central characteristics of a tenancy in common is simply that each tenant is deemed to own by himself, with most of the attributes of individual ownership, a physically undivided part of the entire parcel." 5A M.J., Cotenancy, sec. 5.

Any co-tenant in Virginia has the right to compel partition of the land under Virginia law. Va. Code Ann. sec. 8.01–82 (Supp. 1979).

The interests of the surviving tenants in common cannot affect the disposition by the estate of the decedent's tenancies in common in the farm property. In the instant case such interests were devised to Mr. Pullin's daughter and grandchildren. Upon appropriate conveyances by the executor of petitioner, the devisees will be substituted for Mr. Pullin as tenants in common with Theodore and Bertie. Accordingly, we conclude that the first sentence of section 20.2032A–8(c)(2), Estate Tax Regs., does not include the surviving tenants in common. Theodore and Bertie are not, therefore, required to execute the agreement prescribed by section 2032A(d) of the Code by reason of this sentence in the regulations.

Finally, we turn again to section 20.2032A–8)(c)(2), Estate Tax Regs., which includes in the definition of persons having an interest in the designated property, "co-tenants." The surviving tenants in common are co-tenants. Petitioner contends that the inclusion of that term in the regulations renders them invalid as to the surviving tenants in common. Respondent disagrees.

Treasury regulations "must be sustained unless unreasonable and plainly inconsistent with the revenue statutes." *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948).

Section 2032A(d)(1) provides as follows:

> SEC. 2032A(d). ELECTION; AGREEMENT.—
>
> (1) ELECTION.—The election under this section shall be made not later than the time prescribed by section 6075(a) for filing the return of tax imposed by section 2001 (including extensions thereof), and shall be made *in such manner* as the Secretary or his delegate shall by regulations prescribed. [Emphasis added.]

Treasury regulations are either "legislative" or "interpretative." Section 2032A(d)(1) (quoted above) specifically grants to

the Secretary of the Treasury[4] authority to prescribe regulations as to the *manner* of making the election. Section 2032A(d)(2), on the other hand, grants no such authority to the Secretary. He has no specific authority to prescribe regulations as to the contents of the agreement.

Inasmuch as Congress did not specifically delegate the power to the Secretary to prescribe who would be considered to have an interest in the property, the power of the Secretary, by regulation, to require all "co-tenants" to execute the agreement is derived, if at all, from the general power granted to the Secretary to prescribe regulations under section 7805. That section grants to the Secretary the power to prescribe all "needful" regulations. However, regulations promulgated under the authority of section 7805 are merely interpretative, not legislative. *United States v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982); *State of Washington v. Commissioner*, 77 T.C. 656 (1981), affd. 692 F.2d 128 (D.C. Cir. 1982). Interpretative regulations are entitled to less weight than legislative regulations. *Estate of Boeshore v. Commissioner*, 78 T.C. 523 (1982); *BBS Associates, Inc. v. Commissioner*, 74 T.C. 1118, 1132 (1980), affd. without published opinion 661 F.2d 913 (3d Cir. 1981).

Section 2032A(d)(2) of the Code does not contain the term, "co-tenant." Where the provisions of the statute are unambiguous and its directive specific, the Commissioner has no power to amend it by regulation. *Koshland v. Helvering*, 298 U.S. 441, 447 (1936); *Edward L. Stephenson Trust v. Commissioner*, 81 T.C. 283, 288 (1983). By requiring all co-tenants to execute the agreement, the regulations have imposed an additional condition on the election which is not supported by statutory authority.

The interests which the surviving tenants in common had in the farm property were unchanged by the death of Mr. Pullin, only the identity of their tenants in common changed. The estate tax and potential reduction in estate tax due to special use valuation under section 2032A triggered by the death of their tenant in common, Mr. Pullin, did not alter the property rights of the surviving tenants in common or subject them to estate tax imposed on the property rights of Mr. Pullin which

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[4] Sec. 7701(a)(11)(B) defines "secretary" as the Secretary of the Treasury or his delegate.

passed to qualified heirs by reason of his death. If the interests of the surviving tenants in common are subject to recapture of "additional" estate tax under section 2032A(c), there must be a clear indication in the law that Congress, for the first time, is subjecting to the estate tax, or additional estate tax, interests in property owned by persons other than the decedent. Such congressional intent is lacking. Even if Congress indicated such an intent, it would be inconsistent with section 2033. Section 2033, which Mertens refers to as the "generic section," has remained virtually unchanged since enacted as section 202(a) of the Revenue Act of 1916. 2 J. Mertens, Law of Federal Gift and Estate Taxation, sec. 13.01, at 31 (1959). Indeed, if Congress sought to subject to the estate tax interests in property other than those owned by the decedent, it would have done so in unmistakable terms.

If petitioners must execute the agreement to be bound by the recapture provisions and if "qualified property" includes the interests of the surviving tenants in common as respondent contends, execution of the agreement would subject the property interests of the surviving tenants in common to additional estate tax.

The term, "co-tenant," in section 20.2032A–8(c)(2), Estate Tax Regs., as applied to surviving tenants in common is contrary to the Code and, therefore, invalid. *United States v. Cartwright*, 411 U.S. 546, 557 (1973); *Morris v. Commissioner*, 70 T.C. 959, 998 (1978). A regulation is not a reasonable statutory interpretation unless it harmonizes with the statute's "origin and purpose." *United States v. Vogel Fertilizer Co.*, *supra* at 26; *National Muffler Dealers Association, Inc. v. United States*, 440 U.S. 472, 477 (1979).

In contending that the regulation is valid, respondent relies upon the following language of the report of the staff of the Joint Committee on Taxation:

> One of the requirements for making a valid election is the filing with the estate tax return *a written agreement signed by each person in being who has an interest* (whether or not in possession) *in any qualified real property* with respect to which the use valuation is elected. *This agreement must evidence the consent of each of these parties to the application of the recapture tax provisions to the property.* [Tax Reform Act of 1976, Pub. L. 94–455, 90 Stat. 1520; Staff of the Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1976, 1976-3 C.B. (Vol. 2) 554–555; emphasis added.]

The staff then goes on to separately discuss the effect of the consent of the qualified heirs stating—

> such a consent also amounts to a consent to be personally liable for any recapture tax imposed with respect to the qualified heir's interest in the qualified property. [1976–3 C.B. (Vol. 2), *supra* at 555.]

The staff of the Joint Committee must have been referring only to the interest in such property which is includable in the decedent's estate because section 2032A(c) makes no mention of liability for the recapture of tax other than from qualified heirs. In any event, there is nothing in the legislative history to suggest that surviving tenants in common would be subjected to such liability.

Our opinion is limited to surviving tenants in common which is the only situation before us. We express no opinion as to joint tenants with right of survivorship. As joint tenants are specifically enumerated in section 20.2032A–8(c)(2), Estate Tax Regs., they would not be included in the term "co-tenants" appearing in the same sentence. Likewise we express no opinion as to community property which is specifically covered by section 2032A(e)(10).

Surviving tenants in common are not required to execute the agreement required by section 2032A(c) because there is no statutory authority for such a requirement and, therefore, the requirement of section 20.2032A–8(c)(2), Estate Tax Regs., including them as "co-tenants" is invalid as to them. The election filed by petitioner is valid and petitioner is entitled to the special use valuation of decedent's interests in the designated farm property.

Decision will be entered under Rule 155.

Reviewed by the Court.

FAY, STERRETT, WILBUR, CHABOT, PARKER, WHITAKER, KÖRNER, SHIELDS, HAMBLEN, COHEN, CLAPP, SWIFT, JACOBS, and WRIGHT, *JJ.*, agree with the majority opinion.

NIMS and GERBER, *JJ.*, did not participate in the consideration of this case.

DAWSON, *Chief Judge*, dissenting: I respectfully disagree with the majority opinion. In an attempt to reach what it perceives to be an equitable result, the majority engages in too narrow an interpretation of the language of section 2032A(d)(2). This interpretation results in an inequity to the other parties involved—the surviving tenants in common.

In order to qualify for special use valuation under section 2032A(d)(2), an executor must file a—

> written agreement *signed by each person in being who has an interest * * * in any property* designated in such agreement consenting to the application of subsection (c) with respect to such property. [Emphasis added.]

Section 20.2032A–8(c)(2), Estate Tax Regs., designates those persons with an interest in property as follows:

> (2) *Persons having an interest in designated property.* An interest in property is an interest which, as of the date of the decedent's death, can be asserted under applicable local law so as to affect the disposition of the specially valued property by the estate. Any person in being at the death of the decedent who has any such interest in the property, whether present or future, or vested or contingent, must enter into the agreement. *Included among such persons are* owners of remainder and executory interests, the holders of general or special powers of appointment, beneficiaries of a gift over in default of exercise of any such power, *co-tenants, joint tenants and holders of other undivided interests when the decedent held only a joint or undivided interest in the property or when only an undivided interest is specially valued*, and trustees of trusts holding any interest in the property. An heir who has the power under local law to caveat (challenge) a will and thereby affect disposition of the property is not, however, considered to be a person with an interest in property under section 2032A solely by reason of that right. Likewise, creditors of an estate are not such persons solely by reason of their status as creditors. [Emphasis added.]

The rules governing the effect of the signing of the agreement by persons with an interest in property are provided in section 20.2032A–8(c)(1), Estate Tax Regs., as follows:

> (c) *Agreement to special valuation by persons with an interest in property—* (1) *In general.* The agreement required under section 2032A(a)(1)(B) and (d)(2) must be executed by all parties who have any interest in the property being valued based on its qualified use as of the date of the decedent's death. *In the case of a qualified heir, the agreement must express consent to personal liability* under section 2032A(c) in the event of certain early disposition of the property or early cessation of the qualified use. See section 2032A(c)(6). *In the case of parties (other than qualified heirs) with interests in the property, the agreement must express consent to collection of any additional*

estate tax imposed under section 2032A(c) from the qualified property. The agreement is to be in a form that is binding on all parties having an interest in the property. It must designate an agent with satisfactory evidence of authority to act for the parties to the agreement in all dealings with the Internal Revenue Service on matters arising under section 2032A and must indicate the address of that agent. [Emphasis added.]

The majority narrowly interprets the reference to property in section 2032A(d)(2) to apply only to property owned by the decedent. I think the language of section 2032A(d)(2) is broader and necessarily so. I view the purpose of section 2032A(d)(2) as providing *notice* to all parties with an interest in the property that there is a possibility the property could later be subject to recapture tax. I agree with the majority that the surviving tenants in common herein would not be personally liable for the recapture tax. Respondent has not argued that they would be personally liable and the regulations clearly and properly do not provide for personal liability. However, their interest in the property may be affected by the recapture tax because of the nature of a tenancy in common, i.e., the entire property may have to be sold at a partition sale to satisfy the recapture tax.

In addition, the property the decedent owns is the interest of a tenant in common and, as the majority notes, each tenant in common is deemed to own "a physically undivided part of the entire parcel." Therefore, by definition, the decedent's interest is intertwined with that of the surviving tenants in common.

To support its view that the other tenants in common had no interest in the decedent's property, the majority points out that the property interest of the surviving tenants in common was unaffected by the decedent's death, e.g., their bases remained the same and they incurred no liability for the decedent's estate tax. While I agree with this statement, it is irrelevant to the crucial factor here and that is that the property of the other tenants in common is affected by the section 2032A election.

Under the majority's view, the following scenario is possible. The decedent's estate could elect and qualify for a special use valuation under section 2032A without informing the other tenants in common. Once the election is made, a lien is imposed upon the property pursuant to section 6324B. The estate could then, for some reason, cease its qualified use of the

property. To satisfy its lien, the Government could then sell the property pursuant to section 7403. Since the property herein is held as a tenancy in common, the entire property would have to be sold at a partition sale. Although the other tenants in common would receive their share of the proceeds from such involuntary sale, it is likely that the amount they receive for their interest will be less than they could have received otherwise.

This scenario is not totally unrealistic because a similar situation may be found in *Rodgers v. United States*, 461 U.S. 677 (1983). In *Rodgers*, a husband and wife held a homestead interest in joint tenancy. The husband died and the wife remarried. A Federal District Court ordered the sale of the family home pursuant to section 7403 to meet the separate debts of the husband's estate. The Supreme Court was faced with the question of whether a family home, in which a delinquent taxpayer had an interest at the time he incurred his indebtedness but in which the taxpayer's spouse, who did not owe any of that indebtedness, also had a separate homestead right, could be sold to meet the delinquent taxpayer's separate debts. The Supreme Court upheld the sale based upon the supremacy of Federal law, noting that section 7403 provided for a sale of the property. It rejected any claim of Fifth Amendment conflicts because the wife received money for her interest in the property.

Here the majority ignores the possibility of this scenario perhaps for fear that the other co-tenants would refuse to sign the agreement and prevent the special use valuation. I do not think this fear should motivate our actions. The tax code cannot act to anticipate and resolve family disharmony. In such cases, the decedent's estate could act to partition the property and then elect a special valuation for its portion.

In reaching its result, the majority holds that section 20.2032A–8(c)(2), Estate Tax Regs., is invalid. It adopts a narrow view of section 2032A(d)(1), stating that section 2032A(d)(1) only grants authority to the Secretary to prescribe regulations as to the *manner* of making an election under 2032A. It concludes that the Secretary's authority to prescribe regulations as to the *contents* of the agreement must be derived from section 7805, making section 20.2032A–8(c)(2),

Estate Tax Regs., an interpretative rather than a legislative regulation.

This is a strained construction of section 2032A(d)(1) which is used by the majority to make it easier to invalidate the regulation. But regardless of whether the regulation is legislative or interpretative, I think the regulation is a reasonable interpretation of the statute. The Secretary promulgated section 20.2032A–8(c)(2), Estate Tax Regs., to provide guidance as to the persons who should sign the agreement under section 2032A. In this task the Secretary was guided by the very broad language of section 2032A(b)(2) and by the legislative history. The legislative history does not specifically define who is considered to be a "person with an interest in property." However, the comments of the Joint Committee staff suggest that two such types of persons are envisioned: (1) Qualified heirs, and (2) other persons with an interest. See Staff of Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1976, 1976–3 C.B. (Vol. 2) 554–555. The Secretary, no doubt, realized the danger in a narrow interpretation of who held an interest in property. Accordingly, the Secretary has expressly included the situation herein of "co-tenants" of an undivided interest holding with the decedent in section 20.2032A–8(c)(2), Estate Tax Regs., as persons with an interest who must sign the agreement.[1] This regulation should be upheld unless it is found to be unreasonable and plainly inconsistent with section 2032A. *Edward L. Stephenson Trust Co. v. Commissioner*, 81 T.C. 283, 287 (1983).

Because of the broad language of section 2032A, the comments of the Joint Committee staff, and the possible injustice that can occur to the surviving co-tenants, I think section 20.2032A–8(c)(2), Estate Tax Regs., is reasonable and is not in conflict with the words of the statute. I would sustain the validity of the regulation, and not upset established procedures which have been followed and accepted in the past.

In my judgment, the language of section 2032A(d)(2) should be broadly interpreted to protect *all* parties involved, not just the petitioner herein. The decedent's estate reaps a substantial benefit under the special use valuation of section 2032A. To

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[1] This regulation is cited without comment in R. Stephens, G. Maxfield & S. Lind, Federal Estate and Gift Taxation, par. 4.04[6] (5th ed. 1983), and 5 B. Bittker, Federal Taxation of Income, Estates and Gifts, sec. 132.6.9 (1981 rev.).

obtain the benefit of the election, all that the estate had to do was file an agreement signed by all the persons with an interest in the property. This is certainly a slight burden compared to the benefit the estate would receive. I stress that this is an elective provision and, if the estate expects to enjoy its benefits, it should be required to go through the "hoops" specified by the reasonable procedures of the regulation.

For the reasons stated above, I would hold for the respondent.

SIMPSON, *J.*, agrees with this dissent.

ALBERT MATUT, AS POSSESSOR OF CERTAIN CASH, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 32639–84. Filed May 2, 1985.

Petitioner Albert Matut was in possession of $175,000, the ownership of which he denied and apparently claimed belonged to Mario Lignarolo. Pursuant to sec. 6867, I.R.C. 1954, a termination assessment was made against Matut with respect to his possession of the money and, pursuant to sec. 6851(b), a statutory notice of deficiency was issued to him in his capacity as possessor of certain cash. Albert Matut petitioned the Court, both in his individual capacity and in his capacity as possessor of certain cash, for a redetermination of the deficiency. *Held*, this Court lacks jurisdiction over petitioner in his individual capacity because respondent did not send a notice of deficiency to him in that capacity. *Held, further*, Mario Lignarolo's motion to intervene as a party petitioner is denied.

Albert Matut, pro se.

Michael B. Axman, for the respondent.

OPINION

STERRETT, *Judge*: This case is before the Court on respondent's motion to dismiss for failure to state a claim upon which relief can be granted,[1] pursuant to Rule 40, Tax Court Rules of

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[1] Respondent's motion was directed at petitioner, Albert Matut, both in his individual capacity and in his capacity as possessor of certain cash. On brief, however, respondent conceded that petitioner, in his capacity as possessor of certain cash, had stated a claim upon which relief can be granted.

Practice and Procedure,[2] and on Mario Lignarolo's motion to intervene as a party petitioner. A hearing was held with respect to said motions on December 11, 1984.

The issue to be decided, in determining whether respondent is entitled to prevail on his motion, is whether petitioner, in his individual capacity, has stated a claim upon which relief can be granted. The issue to be decided, in determining whether Mario Lignarolo's motion should be granted, is whether he has a right to intervene as a party petitioner.

Petitioner, Albert Matut, in his individual capacity, resided in Miami, Florida, at the time of filing the petition in this case, and he filed his Federal income tax return for the year ended December 31, 1983, with the Office of the Internal Revenue Service at Chamblee, Georgia.

Petitioner, Albert Matut, in his capacity as possessor of certain cash, is deemed a taxpayer by the statutory presumption set forth in section 6867.[3]

On April 21, 1983, Albert Matut was stopped by the local police authorities and questioned with respect to his possession of $175,000 in cash or its equivalent. Albert Matut denied ownership of the money and apparently told the authorities that the money belonged to Mario Lignarolo.[4] The police took possession of the money and notified Mario Lignarolo and the Internal Revenue Service of their action.

On April 28, 1983, respondent made a termination assessment against Albert Matut and seized cash in the amount of $87,500, which represented one-half of the money found in his possession. In making this assessment, respondent relied on the statutory presumption contained in the aforenoted section 6867.

Albert Matut received the notice of assessment and, on July 11, 1983, he and Mario Lignarolo filed a petition for review of the termination assessment, pursuant to section 7429, in the U.S. District Court for the Southern District of Florida. On October 3, 1983, the District Court dismissed the petition with a finding that the termination assessment was reasonable.

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[2] All Rule references herein are to the Tax Court Rules of Practice and Procedure.

[3] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect for the taxable year in issue.

[4] At the hearing, it was claimed that the money belonged to a Panamanian corporation for which Mario Lignarolo was the resident agent.

Under authority of section 6851(b), a statutory notice of deficiency, dated June 14, 1984, was issued to Albert Matut, as possessor of certain cash, whereby respondent determined a deficiency in his Federal income tax for the year ended December 31, 1983, in the amount of $87,500. Albert Matut timely petitioned the Tax Court, both in his individual capacity and in his capacity as possessor of certain cash, for a redetermination of the deficiency.

Respondent's Motion To Dismiss for Failure To State a Claim

In general, if the Secretary determines that there is a deficiency in tax due with respect to a taxpayer, he is authorized to send him a statutory notice of deficiency. The issuance of the notice entitles the taxpayer to file a petition with the Tax Court for a redetermination of the deficiency. If the taxpayer does petition the Tax Court, the Secretary is prohibited from making both an assessment of the deficiency in tax and a levy for its collection until the decision of the Tax Court becomes final. Thus, the taxpayer is given the opportunity to litigate the determined deficiency in tax without having first to pay the tax alleged to be due. See secs. 6211, 6212, and 6213.

Termination and jeopardy procedures under sections 6851[5]

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[5]The relevant provisions of sec. 6851 are as follows:

SEC. 6851(a). AUTHORITY FOR MAKING.—

(1) IN GENERAL.—If the Secretary finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal himself or his property therein, or to do any other act * * * tending to prejudice or to render wholly or partially ineffectual proceedings to collect the income tax for the current or the immediately preceding taxable year unless such proceeding be brought without delay, the Secretary shall immediately make a determination of tax for the current taxable year or for the preceding taxable year, or both, as the case may be, and notwithstanding any other provision of law, such tax shall become immediately due and payable. The Secretary shall immediately assess the amount of the tax so determined * * * for the current taxable year or such preceding taxable year, or both, as the case may be, and shall cause notice of such determination and assessment to be given the taxpayer, together with a demand for immediate payment of such tax.

. . . . . .

(b) NOTICE OF DEFICIENCY.—If an assessment of tax is made under the authority of subsection (a), the Secretary shall mail a notice under section 6212(a) for the taxpayer's full taxable year * * * with respect to which such assessment was made within 60 days after the later of (i) the due date of the taxpayer's return for such taxable year * * *, or (ii) the date such taxpayer files such return. * * *

and 6861[6] address special situations where the Secretary determines that a deficiency in tax is due from a particular taxpayer and that collection of such deficiency is in jeopardy. These provisions permit the Secretary to make an immediate assessment against the taxpayer for the alleged tax owing prior to a statutory notice of deficiency being issued. These sections are exceptions to the general procedures for assessment of determined deficiencies. After the assessment is made, a notice of deficiency must be issued to the taxpayer.

Congress believed that the termination and jeopardy procedures were not well suited to those cases where the Secretary believed that a tax was due with respect to an amount of an unidentified owner's property, such as cash. More specifically, Congress believed that it was unclear whether sections 6851 and 6861 were available because the Secretary could not determine a deficiency in tax or its amount for an identifiable person. H. Rept. 97-760, at 580, 582 (1982), 1982-2 C.B. 652-654.

To alleviate this uncertainty, section 6867 was enacted. The section provides—

> SEC. 6867(a). GENERAL RULE.—If the individual who is in physical possession of cash in excess of $10,000 does not claim such cash—
>
> (1) as his, or
>
> (2) as belonging to another person whose identity the Secretary can readily ascertain and who acknowledges ownership of such cash, then, for purposes of sections 6851 and 6861, it shall be presumed that such cash represents gross income of a single individual for the taxable year in which the possession occurs, and that the collection of tax will be jeopardized by delay.
>
> (b) RULES FOR ASSESSING.—In the case of any assessment resulting from the application of subsection (a)—
>
> (1) the entire amount of the cash shall be treated as taxable income for the taxable year in which the possession occurs,
>
> (2) such income shall be treated as taxable at a 50-percent rate, and

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[6] The relevant provisions of sec. 6861 are as follows:

SEC. 6861(a). AUTHORITY FOR MAKING.—If the Secretary believes that the assessment or collection of a deficiency, as defined in section 6211, will be jeopardized by delay, he shall, notwithstanding the provisions of section 6213(a), immediately assess such deficiency * * *, and notice and demand shall be made by the Secretary for the payment thereof.

(b) DEFICIENCY LETTERS.—If the jeopardy assessment is made before any notice in respect of the tax to which the jeopardy assessment relates has been mailed under section 6212(a), then the Secretary shall mail a notice under such subsection within 60 days after the making of the assessment.

(3) except as provided in subsection (c), the possessor of the cash shall be treated (solely with respect to such cash) as the taxpayer for purposes of chapters 63 and 64 and section 7429(a)(1).

(c) EFFECT OF LATER SUBSTITUTION OF TRUE OWNER.—If, after an assessment resulting from the application of subsection (a), such assessment is abated and replaced by an assessment against the owner of the cash, such later assessment shall be treated for purposes of all laws relating to lien, levy and collection as relating back to the date of the original assessment.

Respondent argues that, under section 6867(b)(3), Albert Matut may maintain this action with respect to the cash on behalf of Albert Matut, as possessor of certain cash, but that he may not maintain this action in his own name since he denies ownership of the cash. Respondent buttresses his position by citing the portion of the Joint Committee on Taxation's explanation of section 6867, where they state:

Notice with respect to the assessment must be given to the person found in possession of the cash. *However, since that person denies ownership of the cash, he may not prosecute any action with respect to the cash.* [General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, H. Rept. 4961, 97th Cong.; Pub. L. 97-248, 227, 230 (1982), 96 Stat. 324. Emphasis added.]

While it is not entirely clear from our reading of the statute and its legislative history, Congress appears to have been concerned with the tax due on an unidentified owner's property interest in cash or its equivalent. To enable the Secretary to assess and collect such tax, Congress created a statutory presumption that the possessor of such cash would be deemed a taxpayer *solely* with respect to such cash and that the collection of the tax was in jeopardy. The intent behind this statute was to collect the tax owed on the unidentified owner's cash, and the person who was in possession of this money was the vehicle through which such tax would be collected. Congress never intended that the possessor of the cash be brought into this Court in his individual capacity. Since he claims that he does not own the cash, he would not have any personal interest in whether or not a deficiency were determined to exist with respect to such cash. The June 14, 1984, notice of deficiency involved in this case was issued to Albert Matut in his capacity as possessor of certain cash and not to him in his individual capacity. Accordingly, we shall treat respondent's motion to dismiss for failure to state a claim

as a motion to dismiss for lack of jurisdiction as to Albert Matut in his individual capacity, and that motion will be granted.

Mario Lignarolo's Motion To Intervene

Despite the fact that a notice of deficiency was not issued to Mario Lignarolo, he seeks to intervene as a party petitioner in this case. It has been clearly established that a third party, to whom a statutory notice has not been issued, may not become a party petitioner.[7] *Sampson v. Commissioner*, 81 T.C. 614, 616 (1983); *Estate of Siegel v. Commissioner*, 67 T.C. 1033, 1040 (1977); *Guarino v. Commissioner*, 67 T.C. 329, 331–332 (1976); *Cincinnati Transit, Inc. v. Commissioner*, 55 T.C. 879, 881–883 (1971), aff'd. 455 F.2d 220 (6th Cir. 1972). Accordingly, we deny Mario Lignarolo's motion to intervene as a party petitioner.

In his motion, Mario Lignarolo maintains that he owns the money[8] that was seized pursuant to the termination assessment against Albert Matut, and thus he has been deprived of his property. He insists that, since Albert Matut (in his capacity as possessor of certain cash) is a fictitious entity, he is entitled to step into his shoes. As authority for his position, he maintains that section 6867(c) provides for substitution of parties, and that such substitution should be allowed by way of intervention. Section 6867(c) is not applicable to the facts in the instant case. That section explains the effect of a later substitution of the true owner when the assessment against the possessor of cash is abated *and* replaced by an assessment against the owner of the cash. In the instant case, the assessment against Albert Matut, as possessor of certain cash, has not been abated and replaced by an assessment against the owner of the cash. Of course, Mario Lignarolo would be allowed to come forth and testify at Albert Matut's (in his

[7] We are aware of the fact that we have the discretionary authority, under appropriate circumstances, to allow intervention to those who have not been served with a notice of deficiency. In such a situation, the taxpayer would be allowed the status of intervenor, but not the status of party petitioner. *Sampson v. Commissioner*, 81 T.C. 614, 616 (1983). Since this case is before us for the sole purpose of making a redetermination with respect to the tax liability of Albert Matut, as possessor of certain cash, we do not deem this to be an appropriate circumstance in which to utilize our discretionary authority.

[8] At the hearing, however, it was claimed, as noted, that the money belonged to a Panamanian corporation for which Mario Lignarolo was the resident agent.

capacity as possessor of certain cash) trial that he is the owner of the money in issue.

To reflect the foregoing,

An appropriate order will be entered.

WILLIAM W. GRANT, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 13985–79. Filed May 6, 1985.

During 1972, 1973, and 1974, petitioner performed uncompensated legal services for organizations eligible to receive deductible charitable contributions. Also, he represented a client in a divorce proceeding which lasted from 1971 through 1974 and was not compensated for most of the services he rendered in that proceeding. In April 1972, petitioner separated from his wife and vacated his house. His wife rented part of the house to a tenant beginning in September 1972. His wife vacated the house in January 1973. In July 1973, petitioner and his wife were divorced a mensa et thoro. In late 1974 the tenant vacated the house. Petitioner did not report any rental income from the house. In 1975 petitioner and his wife were divorced a vinculo matrimonii, and shortly thereafter the house was sold in a partition sale. *Held*:

1. Petitioner is not entitled to deduct the value of his contributed services to various charitable organizations under sec. 170, I.R.C. 1954; sec. 1.170A-1(g), Income Tax Regs., which disallows such deduction is valid.

2. The value of his uncompensated services in the divorce proceeding is not deductible under sec. 162, I.R.C. 1954.

3. No alimony deduction is allowed under sec. 215, I.R.C. 1954, for payments made in 1972 and in January 1973 since these payments were not made pursuant to a legal obligation incurred by petitioner under a written instrument incident to the divorce or pursuant to a written separation agreement.

4. Petitioner did not hold the house for the production of income and so is not allowed to deduct the maintenance expenses he paid in 1974. Sec. 212(2), I.R.C. 1954.

5. Lisbility determined for additions to tax under sec. 6653(a), I.R.C. 1954.

William W. Grant, pro se.
Robert A. Miller, for the respondent.

CHABOT, *Judge*: Respondent determined deficiencies in Federal individual income taxes and additions to tax under section 6653(a)[1] as follows:

Year	*Deficiency*[2]	*Additions to tax sec. 6653(a)*
1972	$3,660.22	$183.01
1973	3,085.21	154.26
1974	3,378.87	168.94

After concessions by both parties, the issues for decision[3] are as follows:

(1) Whether the value of uncompensated legal services performed by petitioner for charitable, governmental, religious, and educational organizations is deductible under section 170;

(2) Whether the value of services performed by petitioner in a divorce proceeding, in excess of the compensation received by petitioner, is deductible as a business expense under section 162;

(3) Whether payments made by petitioner to his wife during 1972 and 1973 are deductible under section 215;

(4) Whether expenses incurred by petitioner in connection with his former residence are deductible under section 212; and

(5) Whether petitioner is liable for an addition to tax under section 6653(a) for each of the years in issue.

FINDINGS OF FACT

Some of the facts have been stipulated; the stipulations and the stipulated exhibits are incorporated herein by this reference.

When the petition was filed in the instant case, petitioner resided in Oakland, Maryland. For 1972 through 1974, petitioner was a cash basis taxpayer.

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[1] Unless indicated otherwise, all section and chapter references are to sections and chapters of the Internal Revenue Code of 1954 as in effect for the years in issue.

[2] Of these amounts, self-employment taxes under chapter 2 are $573.19 for 1972, $535.50 for 1973, and $532.03 for 1974; the remaining amounts are chapter 1 income taxes.

[3] The medical expense adjustment as to 1974, and the self-employment taxes as to 1972, 1973, and 1974, are derivative and depend on settled issues and our resolution of issues in dispute.

Legal Services

Petitioner is a Maryland attorney and during the years involved was engaged in private practice in Oakland.

Petitioner served as attorney to the mayor and town council of Oakland (hereinafter sometimes referred to as the Oakland government), and received $5,342.01, $1,571.10, and $4,670.00 as compensation for legal services performed in 1972, 1973, and 1974, respectively. These amounts were reported as income on the appropriate years' tax returns. During these 3 years, petitioner also performed legal services for the Oakland government for which he was not compensated. Petitioner did not report the value of these uncompensated legal services as income for 1972, 1973, or 1974. On the Schedule C's of his tax returns for 1972, 1973, and 1974, petitioner deducted $3,042, $1,440, and $1,800, respectively, for "Municipal Work"; these amounts represent the value of the time he spent performing uncompensated legal services for the Oakland government. These uncompensated legal services were performed exclusively for public purposes. Respondent disallowed the deductions on account of the uncompensated legal services.

By appointment of the Governor of Maryland, during 1972 and 1973, petitioner served on the Board of Visitors of Frostburg State College. Furthermore, during 1973, by designation of the Secretary of Natural Resources of Maryland, petitioner served on the Advisory Committee of the Ohio River Basin Commission. During 1972 and 1973, petitioner performed services for various governmental, charitable, educational, and religious organizations for which he was not compensated. Petitioner did not include the value of these services as income for these years. On his tax returns for 1972 and 1973, petitioner deducted $1,126 and $3,478, respectively, as charitable contribution deductions; these amounts represent the value of the time he spent performing uncompensated legal services for these organizations. All of the organizations for which petitioner performed these uncompensated legal services were eligible to receive deductible charitable contributions under section 170. These uncompensated legal services that were performed for governmental bodies were performed exclusively for public purposes. Respondent disallowed the deductions on account of the uncompensated legal services.

In March 1971, petitioner agreed to serve as court-appointed counsel for a client of the Mental Health Section of the Garrett County Department of Health[4] in connection with a divorce proceeding instituted against the client under the then-new no-fault divorce law of Maryland. Petitioner's legal services in that divorce case involved more than 440 hours over about 3 years and included three trials in Prince George's County and several appeals. On his tax return for 1974, petitioner claimed a business bad debt deduction for $12,054.36—the amount by which (a) the sum of (1) the fair market value of his legal services ($13,332) and (2) his out-of-pocket expenses ($704.67) exceeded (b) the $1,982.31 he received for that divorce case. Respondent disallowed this bad debt deduction.

Alimony Payments

On April 4, 1972, petitioner and his wife, Lucille, separated. After their separation, petitioner's divorce counsel advised Lucille's divorce counsel in a letter dated May 30, 1972, that petitioner would provide Lucille with direct support payments.[5] In a letter to petitioner dated June 8, 1972, petitioner's divorce counsel states that he would like to establish with the judge in the divorce action the amount of cash support that petitioner would provide to Lucille.[6]

By a letter dated August 18, 1972, Lucille's counsel advised petitioner's counsel that Lucille was receiving $125 per week[7] and objected to the inadequacy of this amount. During 1972, petitioner made 27 weekly $125 support payments to Lucille, totaling $3,375. Petitioner paid Lucille another $125 on January 23, 1973. No support payments were made between January 23, 1973, and May 29, 1973, because Lucille went to California. She returned sometime in April 1973. The court

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[4] Oakland is the county seat of Garrett County.

[5] The letter states that "However, naturally, Mr. Grant will continue to provide Mrs. Grant with direct support monies for herself and the child."

[6] The letter states that "After the hearing, I would like to be in a position to get something established with him [the judge in the divorce proceeding] insofar as what amount of support you would be providing in cash form to your wife."

[7] The letter states that "As you know, Mrs. Grant has been receiving weekly, a support check in the amount of $125.00. Her experience to date indicates that this is inadequate for her needs and that of Rebecca Linn. Essentially, this is true because Mr. Grant's budget overlooks some major areas of expense and underestimates others."

then awarded her alimony pendente lite in the amount of $200 per month.

During the period May 29, 1973, through July 28, 1973, petitioner made payments to Lucille totaling $700.[6]

On July 16, 1973, petitioner and Lucille were divorced a mensa et thoro by order of the Circuit Court for Garrett County, Maryland.

In July 1974, there was a hearing on the divorce a vinculo matrimonii. The final divorce decree was enrolled in 1975.

No written separation agreement was entered into between petitioner and Lucille. The $3,375 that petitioner paid in 1972 and the $125 that petitioner paid on January 23, 1973, were not paid under a written separation instrument.

Maintenance Expenses

On April 4, 1972, petitioner vacated a house in Oakland, which was owned jointly by petitioner and Lucille. This house had been theretofore used as a residence by both petitioner and Lucille. Lucille remained on the premises and in September 1972 she rented the lower part of the house to a tenant.

The tenant paid the rent directly to Lucille, who kept the rent. The expenses incurred to maintain the premises were paid by Lucille or the tenant. Petitioner did not include in income any rental income from the house for any of the years in question. Petitioner was not aware of the rental details and did not have any idea of the amount of rent collected by Lucille. In January 1973, Lucille vacated the premises, and the tenant remained in possession of the house.

In July 1974, there was a hearing on petitioner's and Lucille's final divorce decree. Sometime between July and December 1974, the tenant also vacated the premises. Since neither Lucille nor the tenant maintained the premises after the tenant departed, petitioner began paying the maintenance expenses for the house because he feared the insurance would be canceled and the utility services terminated. Petitioner intended to sell the house as soon as the divorce proceeding was concluded.

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[6]Respondent concedes that these payments are deductible as alimony in 1973.

On his 1974 tax return, petitioner deducted the expenses shown in table 1, which he paid in connected with the upkeep and maintenance of the house.

Table 1

Insurance	$134.00
Cleaning	239.10
Repairs	98.36
Gas	168.93
Electricity	190.68
Water	43.15
Movers	90.00
	964.22

In 1975, shortly after the final divorce decree was enrolled, the house was sold at a partition proceeding by the Circuit Court for Garrett County. The sale resulted in a capital gain which was reported on petitioner's 1975 tax return.

Petitioner abandoned his personal use of the house before he paid the expenses listed in table 1. Petitioner did not hold the house for the production of income when he paid these expenses.

Negligence, Etc.

Petitioner, who prepared his own tax returns for the years in issue, was aware that section 1.170A-1(g), Income Tax Regs., prohibited a charitable contribution deduction for a contribution of services; he deliberately disregarded the regulation, because he believed that it was invalid.

OPINION

I. Charitable Contributions

In general, petitioner is entitled to deduct, for any year, any contribution or gift to or for the use of any of certain types of organizations, if payment of the contribution or gift is made within that year. Secs. 170(a)(1) and 170(c) (opening flush language).[9] The parties agree that petitioner's services were

[9] SEC. 170. CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS.
(a) ALLOWANCE OF DEDUCTION.—
(1) GENERAL RULE.—There shall be allowed as a deduction any charitable contribution (as

performed for eligible donee organizations (and, in the case of governmental donees, that the services were performed for exclusively public purposes) and also agree as to the value of the services.[10]

Petitioner maintains that he is entitled to deduct under section 170 the value of his uncompensated legal services to the Oakland government for 1972, 1973, and 1974 (originally deducted as business expenses) and the value of his uncompensated legal services in 1972 and 1973 to other organizations eligible to receive charitable contributions. He contends that section 1.170A–1(g), Income Tax Regs., prohibiting such deductions is invalid. Alternatively, petitioner argues that (1) his services coalesced in the various legal documents he delivered to the charitable organizations which constitute a deductible contribution of property under section 170, and (2) the value of petitioner's services are determinable on the record in the instant case and therefore general difficulties in valuation do not constitute a good reason for refusing to allow the specific deductions here in dispute.

Respondent maintains that the regulation is valid. He contends that a longstanding regulation which applies to a subsequently reenacted statute is treated as having received congressional approval and has the effect of law. Respondent further argues that even if petitioner's services are treated as having coalesced in a physical product, petitioner still is not entitled to a charitable contribution deduction, because of the effect of section 170(e)(1)(A).

We agree with respondent.

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defined in subsection (c)) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary or his delegate.

* * * * * * *

(c) CHARITABLE CONTRIBUTION DEFINED.—For purposes of this section, the term "charitable contribution" means a contribution or gift to or for the use of—

[The subsequent amendment of this provision by sec. 1906(b)(13)[sic](A) of the Tax Reform Act of 1976, Pub. L. 94–455, 90 Stat. 1520, 1834, does not affect the instant case.]

[10]

	Oakland government	*Other donees*
1972	$3,042	$1,126
1973	1,440	3,478
1974	1,800	- - -

A. Regulation—Application

Section 1.170A–1(g), Income Tax Regs.,[11] prohibits a charitable contribution deduction for a contribution of services. See *Cupler v. Commissioner*, 64 T.C. 946, 954 (1975). The disputed deductions are for the value of petitioner's uncompensated legal services.[12]

We conclude that, under section 1.170A–1(g), Income Tax Regs., petitioner is not entitled to the disputed deductions.

Petitioner contends that "the value of his services would have coalesced also with the petitioner's output of deeds, opinion letters, reports, legislative drafts, pleadings, resolutions, and ordinances, etc., delivered to the various charitable recipients." Petitioner points to conceptual difficulties in drawing a line separating property from services. To this we make three responses.

Firstly, we acknowledge that such conceptual difficulties exist. See *Holmes v. Commissioner*, 57 T.C. 430, 437 (1971). However we do not believe it is difficult to determine that what petitioner produced is on the services side of the property-services line.[13] We do not believe that the deeds, opinion letters, etc., prepared by petitioner fall on the same side of the line as the original music manuscripts dealt with in *Jarre v. Commissioner*, 64 T.C. 183 (1975); the cataract machine and heart-lung machine dealt with in *Cupler v. Commissioner*, *supra*; the original cartoons and manuscripts dealt with in *Mauldin v. Commissioner*, 60 T.C. 749 (1973); or the movie films dealt with in *Holmes v. Commissioner*, *supra*—a sampling of the cases petitioner cites in support of his argument. Of the cases cited by petitioner, *Goss v. Commissioner*, 59 T.C.

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[11]Sec. 1.170A-1(g), Income Tax Regs., provides as follows:

(g) *Contributions of services.* No deduction is allowable under section 170 for a contribution of services. However, unreimbursed expenditures made incident to the rendition of services to an organization contributions to which are deductible may constitute a deductible contribution. For example, the cost of a uniform without general utility which is required to be worn in performing donated services is deductible. Similarly, out-of-pocket transportation expenses necessarily incurred in performing donated services are deductible. Reasonable expenditures for meals and lodging necessarily incurred while away from home in the course of performing donated services also are deductible. For the purposes of this paragraph, the phrase "while away from home" has the same meaning as that phrase is used for purposes of section 162 and the regulations thereunder.

[12]Petitioner claimed other charitable contribution deductions, evidently for cash or checks; these deductions have not been challenged by respondent.

[13]As to our obligations regarding line-drawing, see, e.g., *Harrison v. Schaffner*, 312 U.S. 579, 583–584 (1941).

594 (1973), is the only one that approaches closely the property-services line. Goss made a gift of two specific essays to a qualified donee organization. The essays were based on the results of a survey that Goss conducted. We noted that Goss "maintained physical ownership over the property before it was donated" to the organization. 59 T.C. at 596. In contrast, the record in the instant case does not specify the particular documents transferred to the donee organizations, nor is there any evidence that petitioner ever maintained physical ownership over the documents he refers to.[14] We do not deny that there are many occasions when a lawyer's documents may have historic value[15] or perhaps a fair market value resulting from interest by collectors. However, nothing in the record in the instant case would support a finding that any of the documents drafted by petitioner falls into either of the foregoing categories.

Secondly, on his tax returns for each of the years in issue, petitioner described the "product" of his business activity as "Legal Services", and not as documents. We have no reason to believe that petitioner's charitable legal work resulted in a different "product" from that of his business legal work. Also, the stipulations speak of petitioner performing uncompensated "services" or "legal services" for the donee organizations; the stipulations do not speak of contributing documents to the organizations.

Thirdly, even if petitioner could properly be said to have contributed property, rather than services, then section 170(e)[16] as modified by the Tax Reform Act of 1969, would

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[14] We note that, in deciding *Goss v. Commissioner*, 59 T.C. 594 (1973), in part for the taxpayers therein, the Court opined that amendments to secs. 170(e) and 1221 by the Tax Reform Act of 1969 probably would require a different result as to contributions made after July 25, 1969. 59 T.C. at 596 n. 2. A similar caution appears in other cases petitioner relies on. See *Holmes v. Commissioner*, 57 T.C. 430, 438–439 (1971); *Mauldin v. Commissioner*, 64 T.C. 749, 758 n. 3 (1973); *Jarre v. Commissioner*, 65 T.C. 183, 184 n. 2 (1975). In the instant case, the contributions are claimed for 1972, 1973, and 1974.

[15] E.g., property (such as that prepared by a lawyer occupying public office) of the sort that gave rise to the provisions of secs. 201(g)(1)(B) and 514 of the Tax Reform Act of 1969, Pub. L. 91–172, 83 Stat. 487, 564, 643.

[16] Sec. 170(e) provides, in pertinent part, as follows:

SEC. 170 CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS.

(e) CERTAIN CONTRIBUTIONS OF ORDINARY INCOME AND CAPITAL GAIN PROPERTY.—

(1) GENERAL RULE.—The amount of any charitable contribution of property otherwise taken into account under this section shall be reduced by * * *

(A) the amount of gain which would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution) * * *

appear to eliminate any deduction by petitioner. (See note 14 *supra*.)

We conclude that petitioner's uncompensated legal services did not coalesce in property that was the subject of charitable contributions. We conclude that the charitable contributions in dispute were contributions of services, within the meaning of section 1.170A–1(g), Income Tax Regs.

We hold for respondent on this issue.

B. Regulation—Validity

The Supreme Court, in *Commissioner v. Portland Cement Co. of Utah*, 450 U.S. 156, 169 (1981), provided the following instructions for testing the validity of a regulation:

> regulations command our respect, for Congress has delegated to the Secretary of the Treasury, not to this Court, the task "of administering the tax laws of the Nation." *United States v. Cartwright*, 411 U.S. 546, 550 (1973); accord, *United States v. Correll*, 389 U.S. 299, 307 (1967); see 26 U.S.C. § 7805(a). We therefore must defer to Treasury Regulations that "implement the congressional mandate in some reasonable manner." *United States v. Correll*, *supra*, at 307; accord, *National Muffler Dealers Assn. v. United States*, 440 U.S. 472, 476–477 (1979). To put the same principle conversely, Treasury Regulations "must be sustained unless unreasonable and plainly inconsistent with the revenue statutes." *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948); accord, *Fulman v. United States*, 434 U.S. 528, 533 (1978); *Bingler v. Johnson*, 394 U.S. 741, 749–751 (1969). * * *

In analyzing the regulation, it may be helpful to consider the following hypothetical. Physician A works without compensation for 1 day at a charitable hospital's clinic. These services are valued at $500. Physician B works for 1 day at his or her usual practice, and contributes the day's net fees (also $500) to the same hospital; the hospital uses that contribution to hire physician C to work for 1 day at its clinic. As an economic matter, A and B are even on the day's work. The hospital has had the benefits of a day's work from each of them (directly from A, indirectly from B). Yet, petitioner would have us declare that A is entitled to reduce his or her other taxable income by $500 (since A's services for the hospital do not generate any taxable income for A) while B is in effect permitted only to offset the $500 of net fees received. We may assume that the Congress has the constitutional power to make this distinction, favoring the services contributor over the cash contributor. However, we do not find anything in the

statute or the legislative history to convince us that the Congress has in fact made this distinction. Respondent's regulation has the effect of giving essentially the same "bottom-line" tax treatment to situations which produce essentially the same "bottom-line" economic results and charitable benefits. Petitioner's approach would require us to invalidate a regulation in order to create vastly different tax results from essentially equivalent sets of facts.

We conclude that respondent's regulation embodies a reasonable interpretation of the statute. Petitioner has not pointed us to any conflict between the statute or the legislative history, on the one hand, and the regulation on the other hand. The regulation meets the Supreme Court's test for validity. See *Commissioner v. Portland Cement Co. of Utah*, *supra*; *Jewett v. Commissioner*, 455 U.S. 305, 318 (1982); *Durbin Paper Stock Co. v. Commissioner*, 80 T.C. 252 (1983); *Friedman Foundation, Inc. v. Commissioner*, 71 T.C. 40 (1978). Compare *Commissioner v. Engle*, 464 U.S. 206, 224–225 (1984), with *Bob Jones University v. United States*, 461 U.S. 574, 596–597 (1983), as to the deference due to *proposed* regulations, and the deference due to long-standing administrative interpretations.[17]

We hold for respondent on this issue.

II. Business Expenses

Petitioner maintains that the value of his legal services rendered in the divorce proceeding for which he received no compensation is deductible as a business expense under section 162, since the resultant publicity helped his law practice and services were performed for this purpose.[18] He argues that performance of assigned pro bono publico work,

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[17] In O.D. 712, 3 C.B. 188 (1920), respondent ruled that "The value of services rendered to charitable institutions may not be allowed as a deduction under * * * [sec. 214(a)11 of the Revenue Act of 1918]." After the enactment of the Internal Revenue Code of 1954, this position was reflected in sec. 1.170-2(a)(2), Income Tax Regs., as follows: "No deduction is allowable for contribution of services." This regulation was adopted Mar. 13, 1958, by T.D. 6285, 1958-1 C.B. 127, 134. Sec. 170 was substantially revised by sec. 201(a) of the Tax Reform Act of 1969 (Pub. L. 91-172, 83 Stat. 487, 549), without any indication that the Congress disapproved of the regulation. The present regulation (note 11 *supra*) was adopted Oct. 3, 1972, by T.D. 7207, 1972-2 C.B. 106, 118.

[18] On his 1974 tax return, petitioner deducted the value of his uncompensated services as a business bad debt. Evidently he has abandoned this contention, consistent with long-established law that a bad debt deduction is not to exceed the taxpayer's basis in the debt. E.g., *Swenson v. Commissioner*, 43 T.C. 897, 899 (1965).

such as the divorce proceeding, is a requirement of his trade or business, and so he is entitled to deduct the fair market value of his services in performing this work. Also, he maintains that section 162(b) is the specific statutory authority for the claimed deduction. Respondent argues that section 162 provides no ground for allowing a deduction for the value of personal services rendered.

We agree with respondent.

Deductions are allowed under section 162(a)[19] for the taxpayer's ordinary and necessary trade or business expenses. In the instant case, petitioner deducted $12,054.36 as the uncompensated value of his services rendered in the divorce proceeding. Since the expenditure of petitioner's labor does not constitute petitioner's payment[20] of a deductible business expense (e.g., *Maniscalco v. Commissioner*, 632 F.2d 6 (6th Cir. 1980), affg. a Memorandum Opinion of this Court;[21] *Rink v. Commissioner*, 51 T.C. 746, 753 (1969)), petitioner is not allowed a deduction under section 162(a).

Petitioner's reliance on section 162(b)[22] and on our opinion in *Marquis v. Commissioner*, 49 T.C. 695 (1968), is misplaced. Firstly, the deduction he claims for the value of his services in the divorce case is not allowable under section 162(a), without regard to section 162(b); section 162(b), by its very words, is a disallowance provision (as we put it in *Marquis*, 49 T.C. at 698–701, section 162(b) is a "limitation" on section 162(a)), and so it cannot operate to revive a deduction that fails the test of section 162(a). Secondly, the deductions claimed, and upheld, in *Marquis* were for the amounts of the "cash disbursements" (49 T.C. at 697) made by the taxpayer therein; in contrast, petitioner seeks deductions herein for the value of his services.

We hold for respondent on this issue.[23]

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[19]Sec. 162(a) provides, in relevant part, as follows:

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) IN GENERAL.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *

[20]The parties have stipulated, and we have found, that petitioner was a cash basis taxpayer.

[21]T.C. Memo. 1978–274.

[22]SEC. 162. TRADE OR BUSINESS EXPENSES.

(b) CHARITABLE CONTRIBUTIONS AND GIFTS EXCEPTED.—No deduction shall be allowed under subsection (a) for any contribution or gift which would be allowable as a deduction under section 170 were it not for the percentage limitations, the dollar limitations or the requirements as to the time of payment, set forth in such section.

[23]On his 1974 tax return, petitioner computed the deduction dealt with in this issue, as follows:

III. Alimony Payments

Petitioner contends that he is entitled to deduct his payments to Lucille, made in 1972 and through January 23, 1973, as alimony because the amounts were paid pursuant to a written separation agreement. Alternatively, petitioner maintains that he made these payments pursuant to a legal obligation incurred by him under a written instrument incident to the divorce. Respondent maintains that since (1) none of the payments was made pursuant to a court order or decree of support and (2) no written separation agreement existed for the period in question, it follows that no alimony deduction is allowable.

We agree with respondent.

Section 215(a)[24] provides a deduction for amounts paid by a taxpayer to a former spouse if the former spouse is required to include these amounts in gross income under section 71. Under section 71(a),[25] the former spouse's gross income in-

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444.4 hrs × 30.00/hr	=	$13,332.00
Court costs advanced:		704.67
		14,036.67
Paid		1,982.31
		12,054.36

In the notice of deficiency, respondent disallowed $12,054.36. In effect, petitioner has been permitted to deduct the $1,277.64 amount by which the payment to petitioner exceeded his costs. Respondent does not explain why this $1,277.64 should be treated differently from the $12,054.36 which he disallows. Under the circumstances, we leave the parties where we find them as to this $1,277.64.

[24] SEC. 215. ALIMONY, ETC., PAYMENTS.

(a) GENERAL RULE.—In the case of a husband described in section 71, there shall be allowed as a deduction amounts includible under section 71 in the gross income of his wife, payment of which is made within the husband's taxable year. * * *

[The subsequent amendment of this provision by section 422(b) of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 797, does not affect the instant case.]

[25] SEC. 71. ALIMONY AND SEPARATE MAINTENANCE PAYMENTS.

(a) GENERAL RULE.—

(1) DECREE OF DIVORCE OR SEPARATE MAINTENANCE.—If a wife is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, the wife's gross income includes periodic payments (whether or not made at regular intervals) received after such decree in discharge of (or attributable to property transferred, in trust or otherwise, in discharge of) a legal obligation which, because of the marital or family relationship, is imposed on or incurred by the husband under the decree or under a written instrument incident to such divorce or separation.

(2) WRITTEN SEPARATION AGREEMENT.—If a wife is separated from her husband and there is a written separation agreement executed after the date of the enactment of this title, the wife's gross income includes periodic payments (whether or not made at regular intervals) received after such agreement is executed which are made under such agreement and because of the marital or family relationship (or which are attributable to property transferred, in trust or otherwise, under such agreement and because of such relationship). This paragraph shall not

cludes periodic payments received from the taxpayer (1) under a decree of divorce or separate maintenance, (2) under a written separation agreement, or (3) under a decree for support; in order for petitioner to succeed, he must show that the payments in dispute fall into one of these three categories.

Section 71(a)(1) applies to payments "received after" a decree of divorce or of separate maintenance. Respondent's concession (see note 8 *supra*), leaves in dispute only those payments made by petitioner to Lucille up to January 23, 1973. The Circuit Court's decree awarding alimony pendente lite was not made until after that date, according to petitioner's testimony. The Circuit Court's decree of divorce, a mensa et thoro was not made until July 16, 1973. It appears, then, that none of the payments here in dispute was made after a decree of divorce or separate maintenance. Accordingly, none of the payments here in dispute qualifies for inclusion in Lucille's income under section 71(a)(1). It follows that none of the payments here in dispute is deductible by petitioner under section 215(a).

There is no evidence that any one of the payments here in dispute was made under a support decree. Accordingly, the amounts of these payments are not includable in Lucille's income under section 71(a)(3), and are not deductible by petitioner under section 215(a).

In order to qualify under section 71(a)(2), the payments in dispute must be shown to have been made by petitioner to Lucille under a written separation agreement. The parties have stipulated that "No written separation agreement was entered into between the petitioner and his wife." Evidently, the parties do not regard their stipulation as having foreclosed the question of whether three letters constitute, in the aggregate, a written separation agreement sufficient to satisfy this requirement of the statute.

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apply if the husband and wife make a single return jointly.

(3) DECREE FOR SUPPORT.—If a wife is separated from her husband, the wife's gross income includes periodic payments (whether or not made at regular intervals) received by her after the date of the enactment of this title from her husband under a decree entered after March 1, 1954, requiring the husband to make the payments for her support or maintenance. This paragraph shall not apply if the husband and wife make a single return jointly.

[The subsequent amendment of this provision by section 422(a) of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 795, does not affect the instant case.]

Petitioner offered into evidence three letters (see notes 5, 6, & 7 *supra*), which, he contends, when viewed in the aggregate constitute a written separation agreement. The three letters fail to satisfy the requirements of the statute, which (1) requires that there be "a written separation agreement" and (2) applies to "periodic payments * * * received after such agreement is executed which are made under such agreement".

Firstly, the only writing executed on Lucille's behalf—the August 18, 1972, letter (note 7 *supra*)—is a complaint about the inadequacy of the rate of payment and not an agreement to the rate of payment. Thus, the record in the instant case does not include any *writing* (or set of writings) that constitutes an *agreement* between Lucille and petitioner. *Estate of Hill v. Commissioner*, 59 T.C. 846, 856-857 (1973). An oral agreement is insufficient. See *Gordon v. Commissioner*, 70 T.C. 525, 529 (1978), interpreting similar language in section 71(a)(1). In *Prince v. Commissioner*, 66 T.C. 1058 (1976), attorneys for the husband and wife reached an agreement in the course of a divorce trial and recited that agreement into that divorce case's record as their joint stipulation. We concluded that the certified transcript of that stipulation constituted a written agreement. The record in the instant case falls far short of showing such a written agreement. The most that can be said about the three letters is that they are evidence of a course of action; petitioner determined that he ought to make payments of $125 per week to Lucille, and he made these payments for 28 weeks.

Secondly, the course of weekly payments must have begun no later than June 1972. The August 18, 1972, letter refers to such payments already having been made. Payments made before the written agreement was executed are not eligible for treatment under section 71(a)(2). Even if a written agreement ultimately was executed, nothing in the record would permit us to reach a conclusion that any of petitioner's disputed payments to Lucille were made *after* any such agreement was executed. See *Gordon v. Commissioner*, 70 T.C. at 530.

We conclude, and we have found, that petitioner's disputed payments to Lucille were not paid under a written separation agreement.

Petitioner relies on a statement in *Lerner v. Commissioner*, 195 F.2d 296, 298 (2d Cir. 1952), revg. 15 T.C. 379 (1950), in which the Court of Appeals for the Second Circuit interpreted the statutory phrase "written instrument incident to such divorce". The instrument in *Lerner* was an agreement between Lerner and his wife describing in great detail the rate of the payments, the purpose of the payments, and even the mechanical procedure of the payments. The dispute resolved by the Court of Appeals was whether the written instrument was incident to the divorce, not whether there was a written instrument.

Petitioner also relies on our opinion in *Cramer v. Commissioner*, 36 T.C. 1136 (1961), citing *Lerner* with approval. In *Cramer* we found that there was a specific instrument that was negotiated, revised, and executed by Cramer and her husband. In *Cramer*, also, the question presented was whether the written instrument was incident to the divorce, not whether there was a written instrument.

Both *Cramer* and *Lerner* are distinguishable from the instant case, as to the factual setting and also as to the legal issue that those opinions analyze.

We hold for respondent on this issue.

IV. Maintenance Expenses

Petitioner contends that he is entitled to deduct his maintenance expenses for the house under section 212 because he held the house for the production of income. He maintains that the jointly owned house was converted by his wife to rental property when she vacated the premises in January 1973 and the property remained rented to a tenant. Therefore, petitioner argues, although the tenant vacated the premises sometime after June 1974, petitioner never converted the property back to a personal residence and he assumed the maintenance of property held for the production of income.

Respondent agrees that, if we were to conclude that petitioner held the house for the production of income, then petitioner would be entitled to a deduction for the maintenance expenses. However, respondent argues, since petitioner neither received any income from the rental property nor entered into any of the business arrangements, the house had never been converted to rental property for petitioner's tax purposes. Also,

respondent contends that petitioner did not maintain the house for postconversion appreciation purposes and, therefore, petitioner is not entitled to deduct the maintenance expenses of the property.

We agree with respondent.

Under section 212(2),

> there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
>
> * * * * * * *
>
> (2) for the management, conservation, or maintenance of property held for the production of income; * * *

Whether an individual holds property for the production of income is a question of fact, and depends on the purpose or intention of the individual, as gleaned from all of the facts and circumstances of the particular case. Several factors are to be considered in determining this intention. Where the property is the individual's residence, these factors include (1) the length of time the house was occupied by the individual as his residence before placing it on the market for sale; (2) whether the individual permanently abandoned all further personal use of the house; (3) the character of the property (recreational or otherwise); (4) offers to rent; and (5) offers to sell. In addition, if the individual offers his house only for sale, then in order to be treated as holding the property for the production of income he must intend to realize gain representing postconversion appreciation in the fair market value of the property. *Meredith v. Commissioner*, 65 T.C. 34, 41–42 (1975), and cases cited therein.

The burden of proof is on petitioner (see, e.g., *Welch v. Helvering*, 290 U.S. 111, 115 (1933); *Meredith v. Commissioner*, 65 T.C. at 41; Rule 142(a), Tax Court Rules of Practice and Procedure) to show that he held the house for the production of income.

When petitioner vacated the premises, in April 1972, the house was left for Lucille's use, at least for the time being. (For circumstances under which petitioner might have been allowed alimony deductions on account of his expenditures for Lucille's benefit, see J.E. Maule, Taxation of Residence Transactions 437-441 (1985).) Although the evidence is sparse, it

seems clear that Lucille was to bear the effect of any expenses and was to be entitled to receive any income to be derived from the house. Petitioner did not include in income any rental income from the house for any of the years in question. There is no basis in the record to attribute to petitioner any of Lucille's activities in renting out the house.[26]

As in *Meredith* (65 T.C. at 40–41), we conclude that petitioner abandoned his personal use of the house before he paid the expenses for which he seeks a deduction. However, during the time petitioner paid these expenses, he held the house only for sale as soon as the divorce proceeding was concluded. In fact, the house was sold in 1975, shortly after the final divorce decree was enrolled. We have no evidence that petitioner held the house for appreciation purposes after he began to assume the burden of maintenance expenses. Thus, as in *Meredith*, petitioner never converted the property to a section 212(2) purpose. We conclude that petitioner did not hold the house for the production of income when the expenses were paid.

We hold for respondent on this issue.

V. Section 6653(a)—Negligence, Etc.

An addition to tax under section 6653(a)[27] is imposed if any part of any underpayment of tax is due to negligence or intentional disregard of rules or regulations. Petitioner has the burden of proving error in respondent's determinations that this addition to tax should be imposed against him. *Bixby v. Commissioner*, 58 T.C. 757, 791–792 (1972).

Although the instant case presents many issues, the only one giving rise to respondent's determination of the addition to tax under section 6653(a) is the charitable contributions issue (issue I *supra*).

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[26] Cf. *Lebens v. Commissioner*, T.C. Memo. 1980-201.

[27] SEC. 6653. FAILURE TO PAY TAX.

(a) NEGLIGENCE OR INTENTIONAL DISREGARD OF RULES AND REGULATIONS WITH RESPECT TO INCOME OR GIFT TAXES.—If any part of any underpayment (as defined in subsection (c)(1)) of any tax imposed by subtitle A or by chapter 12 of subtitle B (relating to income taxes and gift taxes) is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.

[The subsequent amendments of this provision (by sec. 101(f)(6) of the Crude Oil Windfall Profit Tax Act of 1980, Pub. L. 96-223, 94 Stat. 229, 253, by sec. 722(b)(1) of the Economic Recovery Tax Act of 1981, Pub. L. 97-34, 95 Stat. 172, 342, and by sec. 107(a)(3) of the Technical Corrections Act of 1982, Pub. L. 97-448, 96 Stat. 2365, 2391) do not affect the instant case.]

In claiming deductions for the fair market value of his services, petitioner intentionally disregarded section 1.170A-1(g), Income Tax Regs., because he believed the regulation to be invalid. We have concluded that his belief was incorrect. We have pointed out (note 14 *supra*) that a number of the opinions on which he relies—several of which opinions were issued before petitioner filed some or all of the tax returns for the years in issue—indicate that section 170(e), as enacted by the Tax Reform Act of 1969, would have eliminated any deduction in petitioner's case even if the regulation was invalid. We conclude that petitioner had no reasonable basis for claiming these deductions in the teeth of both the regulation and the statute.[28]

We hold for respondent on this issue.

To take account of respondent's concessions,

Decision will be entered under Rule 155.

GILBERT R. MILLER AND RITA MILLER, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 20724–83. Filed May 13, 1985.

Held, petitioners' losses in trading in commodity futures straddles during 1979 allowed pursuant to the provisions of sec. 108 of the Tax Reform Act of 1984.

William S. Huff, Charles A. Ramunno, and *Bruce N. Lemons*, for the petitioners.

Theodore J. Kletnick and *William F. Garrow*, for the respondent.

WHITAKER, *Judge*: Respondent determined a deficiency in income tax for petitioners' 1979 taxable year in the amount of $104,236. Due to concessions, the sole issue for determination is the deductibility of short-term losses in the amount of

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[28] We leave to another day the applicability of sec. 6653(a) where the taxpayer has a reasonable basis for his position, in light of *Druker v. Commissioner*, 697 F.2d 46, 52–56 (2d Cir. 1982), revg. in part 77 T.C. 867, 874–876 (1981).

$103,325 from trading in commodity futures straddles claimed on Schedule D of petitioners' income tax return.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. Throughout the year 1979, petitioners were husband and wife, although they are now divorced. At the time of the filing of the petition in this case, each of petitioners was a resident of the State of Colorado.[1] Petitioners' income tax return for the year 1979 was filed, using the cash method of accounting. Mrs. Miller is involved in this proceeding only by reason of having filed a joint return with Mr. Miller (referred to herein as petitioner).

Only a brief description of commodity futures trading is necessary.[2] In general, a futures contract is an agreement to deliver or to receive a specified quantity and grade of a designated commodity during a designated month in the future (a position).[3] A futures contract is either a contract to sell—a "short" position, or a contract to purchase—a "long" position. A single position calling for the purchase or sale of a designated commodity is described as an "open contract" whereas acquisition by the same person of two or more positions calling for the purchase of a specified commodity in one or more months and for the sale of the same commodity in one or more different months is described as a straddle. Each of such positions is sometimes referred to as a "leg" of the straddle.[4] Customarily, persons trading in commodity futures do not hold contracts to the date of delivery or make or receive delivery of the specified commodity; rather, such contracts are generally closed out by the acquisition of an offsetting purchase or sale of the same quantity of the commodity for the same month.

Whenever an open position is held, price changes in the commodity futures directly affect the economic position of the

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[1] Mr. Miller at the time of trial was a resident of California.

[2] The mechanics of trading through the Commodity Exchange, Inc., in commodity futures is discussed in detail in our decision in *Smith v. Commissioner*, 78 T.C. 350 (1982), to which reference is made.

[3] The word "position" is of particular importance in the application of sec. 108 of the Tax Reform Act of 1984 which is dispositive of this case.

[4] For definitional purposes, it is immaterial whether the delivery month of the long position or of the short position is nearer to the date of acquisition of the straddle.

holder. In a straddle, by contrast, the holder is concerned only with changes in the spread—the difference between the price of each leg of the straddle. If the prices of the short and long legs of the straddle move exactly in tandem so that the spread does not change, the holder will suffer no economic consequence since the unrealized gain and loss will be exactly offset. On the other hand, if the spread widens or narrows, the holder will incur either an economic net gain or loss.

Whenever any leg of a straddle is closed out by the purchase of an exactly opposite position, tax consequences normally will result, either a realized gain or loss. If no other action is taken, where the straddle consisted of only two positions, that position which was not closed out becomes simply an open contract. In straddle trading, however, and particularly in tax-motivated straddle trading, customarily the loss leg will be closed out in order to realize a tax loss and a similar position acquired in a different month so that the economic consequences and risks to the holder are minimized. This substitution of one position for a similar position in a different month is sometimes referred to as a "switch."

Straddle transactions having as their principal objective the achievement of "deferral" (postponing to a later year an already realized gain in an unrelated transaction) or "conversion" (changing a short-term capital gain on an unrelated transaction to a long-term capital gain) are commonly referred to as "tax straddles" by the brokerage industry. Trading in tax straddles will always show a pattern of switching of the loss leg in the initial year in order to generate tax losses (which are utilized to offset the realized unrelated gain) while minimizing economic losses. Long-term capital gains are achieved by holding the profit position (if a long position) for more than 6 months prior to closeout.[5]

It is generally understood that substantially all (85 to 90 percent) commodity futures trades result in losses. Nevertheless, there are opportunities for realizing profits in trading in commodity futures, including trading in straddles. The use of a straddle tends to minimize the risk of losses, but at the same

[5]Long-term capital gains can be achieved only through a long position. Short-term capital gains on a short position cannot be converted into long-term capital gains because of the anti-conversion rules set forth in sec. 1233(b). Thus the maximum tax advantage is achieved where gain is on the long position and loss on the short.

time reduces the profit opportunities. Every position held by a person is matched by an exactly opposite position (or series of positions) held by one or more other persons. Thus, a loss realized on closeout will be matched by the realization of gain in the same amount, provided the opposite position was acquired at the same time and held to close out.

Beginning in 1971, Merrill Lynch Pierce Fenner & Smith, Inc. (Merrill Lynch), which as broker handled petitioners' trades which are in issue, formed in its New York City office a unit within its commodity division referred to as the "Tax Straddle Department,"[6] under the management of Tom O'Hare. During the relevant period in 1979 and 1980, this department also included Ray Shevlin. This department assisted Merrill Lynch field account executives in achieving tax losses and deferrals desired by customers by recommending and helping to implement trading strategies in commodity futures. During the period 1975 through 1980, most of the customers who utilized the services of the Merrill Lynch Tax Straddle Department desired and, in fact, achieved substantial tax losses through switches made in the initial year of the straddle transaction or series of transactions.

Petitioner is a college graduate with a degree in geology, and for approximately 20 years his principal income-producing activities have been in various aspects of oil and gas exploration. Since the year 1964, petitioner has been actively trading for his own account in commodity futures. Petitioner has always used what is known as a nondiscretionary account with his brokers, in that investment decisions were and are made by him personally. Petitioner generally acquired open positions and rarely held any position for a substantial period of time. In 1969, petitioner and several other individuals formed a corporation called Computrade, Inc., to engage in commodity futures trading on a large scale. This continued until 1974 or 1975, and during the initial years, petitioner personally handled the corporation's trading activities. Computrade, Inc., made more than 1,000 trades in a variety of futures contracts, all of which were open positions.[7] By the year 1979, petitioner

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[6] This department was apparently also known as the Financial Services Department.

[7] On this record, we cannot determine how many of these trades were handled by petitioner personally, but the utilization of only open positions clearly was consistent with and must have reflected petitioner's personal trading philosophy.

was a sophisticated trader in commodity futures transactions, with the knowledge, experience, and confidence to make futures trading decisions on the basis of his own analysis of facts and on recommendations solicited by him from brokers and their account executives. It was petitioner's practice when "playing" commodities to check on his positions at a minimum every day, because it "is a very high-risk game."

During the period 1975 to 1983, petitioner made 158 commodity futures trades for his personal account—almost 20 per year. Of these, 114 were open positions and 44 were straddles. Of the 44 straddles, only 4 included switches. Three of these four are the transactions at issue here—gold futures straddle trades made between October 19, 1979, and April 21, 1980.[8] These trades are set forth in detail in Appendix A (pp. 848–849 *infra*) attached hereto. They required an initial margin deposit of about $6,000.[9]

Petitioner opened an account with the Denver office of Merrill Lynch in approximately 1964, consistently using Glenn Mathers, a college friend, as his account executive. Until 1975, trades through Mathers were in stocks and bonds. Petitioner's Merrill Lynch commodities account was opened on December 31, 1974. Prior to 1975, other brokers were used for commodity futures trading.

A number of facts are of particular significance in this case. Prior to the initiation of petitioner's gold futures trades, Mathers had never consulted with or utilized the expertise of the Merrill Lynch Tax Straddle Department for the benefit of

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[8]The numbers of trades, straddles, and switches during the period 1975–83 were stipulated. Since the terms "transaction" and "trade" were not defined, we cannot determine definitively what portion of the 44 straddles the gold straddles here in issue represent. (See note 13 *infra*.) As shown by Appendix A and viewing as we do the trades on Dec. 3 and 4, 1979, as parts of a single trade, these gold straddles included four distinct straddles, three of which were acquired in 1979 and the fourth in 1980. The second straddle was created by switching one position. The third straddle was a so-called butterfly, created by switching one short position into two short positions. Thus, two switches occurred in 1979, the only year before us, and one in 1980.

[9]Margin is the amount of money or collateral required to be deposited by a customer with his broker when trading in commodity futures is initiated. It does not constitute a part payment on the purchase price of the futures contracts acquired but rather serves to insure the brokers against loss incurred in the futures trading. The original margin amount is fixed by the particular exchange through which the trading is effected. In all cases, margin is substantially less than the aggregate cost of the initial positions. Additional margin may be required, or refunds may be made, to offset unrealized economic losses or gains incurred during trading. Generally, the amount of required original margin is greater for trades in open futures contracts than in straddles since the risk is substantially greater. As a result, profit or loss may be measured or tested against the aggregate margin deposited—the money required to engage in the trading—as well as against the cost of the futures contracts acquired.

petitioner (or any other customer), and he did not utilize the Tax Straddle Department for petitioner's trades after this series of gold straddles. Moreover, it was only with respect to these gold futures trades that Mathers used a New York specialist to place the trades with a floor broker at the Commodity Exchange, Inc. Mathers, himself, placed all of petitioner's other futures trades with a floor broker. At some point shortly before the first gold straddle trade on October 19, 1979, Mathers talked to O'Hare and was referred to Shevlin for expert assistance.[10] Each of petitioner's gold futures transactions was discussed by Mathers with Shevlin prior to submission of the recommendation to petitioner for approval. Shevlin's recommendations were either volunteered by him to Mathers or solicited by Mathers and conveyed to petitioner by Mathers.[11] Petitioner directed or approved each acquisition and disposition of each position.

Shevlin recorded on his working papers at the outset that petitioner's tax objective was a $100,000 tax loss for the year 1979. That information was directly or indirectly provided to Shevlin by Mathers. This tax objective was known to petitioner and had his approval, although whether the precise sum of $100,000 was suggested by petitioner or by Mathers or by Shevlin is unclear.[12] Petitioner was advised by Mathers as to the entire strategy of this series of gold trades which was a coordinated plan recommended by Shevlin to achieve a prescribed tax loss objective. As can be seen from Appendix A (pp. 848–849 *infra*), the series of switches effected during December

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[10]Mathers now recalls only that O'Hare had a reputation for expertise in commodity futures trading, including straddles, and that O'Hare's department was involved in gold straddles. Why he felt impelled in this instance to consult with the Tax Straddle Department, he could not satisfactorily explain. However, throughout his testimony, Mathers' memory was poor, conveniently so, it would seem.

[11]Petitioner had no direct contact with Shevlin until the time of trial preparation and no contact at all with O'Hare.

[12]Although petitioner strenuously denies tax motivation as well as knowledge of this tax objective, his denials are not credible. There was a substantial similarity between the trades executed by petitioner and those of a number of the other customers of the Tax Straddle Department. In particular, a number of the other customers of this department also made petitioner's initial transaction on the same date, though in different units. Petitioner's gold straddle trades were contrary to his customary trading practice of acquiring open positions, and his use of switches in every one of this series of gold trades is almost unique in petitioner's commodity futures trading. Finally, the retention by petitioner of a single position for 6 months was without precedent. There is no satisfactory explanation for these uncustomary futures trades other than that they reflect the tax strategy of the Merrill Lynch Tax Straddle Department and were designed to achieve the $100,000 tax loss objective.

1979 created $103,325 of tax straddle losses which were included in the $99,708 net short-term commodity losses claimed by petitioner on his 1979 tax return. The series of gold futures straddle transactions ending in April 1980 resulted in an overall net loss for the 6-month period of slightly over $25,000. Petitioner's series of switches are typical of tax straddles. We note particularly that the initial long position of 15 August 1980 contracts which showed a continuing gain was held for 6 months and 2 days, providing a long-term capital gain. All of the switches, on the other hand, were in petitioner's short positions in order to recognize losses.

The initial gold straddle transaction of petitioner on October 19, 1979, was placed and approved by petitioner with the primary intent or motive of realizing tax losses in 1979 in an amount approximating $100,000 and long-term capital gains in 1980. It was contemplated by petitioner, Mathers, and Shevlin at the time of placing the order to acquire the October 19, 1979, position that one or more switches would be effected in order to realize the desired 1979 tax loss goal. Thus, the October 19, 1979, transaction was a part of and the initial step in petitioner's "entire commodity tax straddle scheme," designed to achieve the 1979 tax loss goal and the deferral to 1980 of unrelated 1979 capital gains. We assume that petitioner had an incidental profit motive, but it is more realistic to conclude—as we do—that he intended that the long-term gain which he expected to realize by holding the long element of the initial straddle would allow him to offset the realized losses and transaction costs.[13] Each of the succeeding gold futures trades, including the final closeout in April 1980, was similarly tax motivated. Thus, each disposition of a position in December 1979 was intended to achieve the tax loss thereby realized. Each new straddle simultaneously acquired was tax motivated and each reduced the profit potential. However, gain or loss in each position depended upon market movement over which these players had no control.

Interest rates and the prices of gold and gold futures were exceedingly high during this 1979–80 period. Upon the date on which each separate gold straddle was acquired by petitioner, it was reasonable to believe that the prices of gold and hence

[13] Commissions and fees of $3,447.50 were paid by petitioner to Merrill Lynch in connection with the gold futures straddles in issue.

gold futures, would fall instead of continuing to rise. A relatively small downward movement in the prices of gold and gold futures during the 1979–80 period involved in petitioner's gold futures trades could have produced a net economic profit, after taking into account transaction costs and fees, on each separate straddle on the respective dates on which each position was closed out, including the final closeout of all positions on April 21, 1980. In that event, the 1979 net loss shown in Appendix A would have been converted into a net gain. Therefore, there was for each of petitioner's 1979 gold straddles a reasonable prospect of some profit at the time acquired.

OPINION

Were it not for the interpretative problem created by the application to this case of section 108 of the Tax Reform Act of 1984 (section 108),[14] our findings of fact would mandate the application here of our recent decision in *Smith v. Commissioner*, 78 T.C. 350 (1982), as amplified by *Fox v. Commissioner*, 82 T.C. 1001 (1984). In fact, but for section 108, much of the language of the critical portion of our opinion in *Smith* might be repeated verbatim. For example, respondent here argues that petitioner's losses are not allowable because they were not "incurred in any transaction entered into for profit" within the meaning of section 165(c)(2).[15] As we said in *Smith*:

> For purposes of applying section 165(c)(2), respondent has treated the relevant "transaction" as an investment in a "commodity tax straddle," while petitioners have on the whole treated the transaction as an investment in * * * straddles. This distinction is an important one and goes far toward explaining the different conclusions reached by petitioners' and respondent's experts as to the potential historical profitability of petitioners' investments. * * * We agree with respondent that what petitioners invested in with Merrill Lynch were commodity tax straddles—i.e., a prearranged, planned sequence of trading along the lines studied by respondent's expert—not simple investments in * * * straddles held solely for nontax profit objectives. For purposes of section 165(c)(2), then, we hold the relevant "transaction" to encompass petitioners' entire commodity tax straddle scheme.

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[14] Division A of the Deficit Reduction Act of 1984, 98 Stat. 494.

[15] All section references, with the exception of sec. 108, are to the Internal Revenue Code of 1984 as amended and in effect during the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

> The mere fact that petitioners may have had a strong tax-avoidance purpose in entering into their commodity tax straddles does not in itself result in the disallowance of petitioners' losses under section 165(c)(2), provided petitioners also had a nontax profit motive for their investments at the time. Such hope of deriving an economic profit aside from the tax benefits need not be reasonable so long as it is bona fide. However, the existence of a nontax profit objective is a question of fact on which the petitioners bear the burden of proof. In ascertaining petitioners' subjective intent, this Court is not bound by the taxpayer's uncontradicted assertions of proper motive made * * * years after the events in issue.
>
> [Contemporary] evidence, we think, belies any nontax motive on petitioners' part.
>
> [78 T.C. at 390–391; citations and fn. ref. omitted.]

But for section 108, on the authority of *Smith*, we would be prepared to find against petitioner since petitioner "lacked the requisite economic profit objective necessary to enable [him] to deduct [his] commodity tax straddle losses in [1979]." 78 T.C. at 394. A profit motive which is merely incidental does not suffice for section 165(c)(2). *Fox v. Commissioner*, *supra*.

Petitioner, here, insists that he initiated his gold transactions with a profit objective, thinking in 1979 that both gold prices and interest rates would go down. In point of fact, exactly the opposite happened. It is probably true that petitioner, a sophisticated commodity futures trader, hoped that in some fashion he might make an overall profit or at least break even. Petitioner's entire business life, during which his principal activity has been oil and gas exploration, has many aspects of professional gambling. We are convinced that petitioner had at least an incidental profit motive in every business transaction which he entered including these gold straddles, but his contention that he was unaware of, or indifferent to, the tax consequences of the switches in positions made in December 1979 is simply not believable. Petitioner's intelligence, his experience in commodity futures trading, and his sophistication as a businessman and commodities trader belie his efforts to convince us that he was not fully aware that realization of a tax loss during the year 1979 was the primary motive for his entering into this series of gold straddle transactions.[16] While

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[16] As a witness, we found petitioner to be neither forthright nor convincing. His answers to many questions put to him by his own counsel, on cross-examination and by the Court, were ambiguous often with an appearance of a studied attempt at confusion. The following colloquy between the Court and petitioner is illustrative:

> Q. And it is on account of those factors that you found it necessary to change your position

we do not doubt his testimony that he had no contact with Shevlin prior to trial preparation, we cannot and do not credit the implication from his testimony that he was unaware that the advice he received from account executive Mathers was derived from the Merrill Lynch Tax Straddle Department and was geared toward achievement of a $100,000 tax loss during the last quarter of 1979. We are certain that Shevlin would not have established the $100,000 loss objective without being convinced by Mathers that it represented this customer's goal. We are further convinced that the relationship of Mathers and petitioner was such that Mathers would not have conveyed such information to Shevlin without petitioner's knowledge and concurrence. Mathers was simply the go-between, conveying the tax straddle expert's recommendations to petitioner and petitioner's authorization to Shevlin.

The pattern of switches in these gold commodity futures transactions, totally different from petitioner's trading pattern during the prior 15 years, is too significant to ignore. The self-serving testimony[17] of petitioner and of Shevlin, that each switch was profit oriented is unconvincing, especially when one understands that each of the 1979 transactions subsequent to the acquisition of the initial straddle, in fact realized tax losses and slightly over achieved the $100,000 loss goal, while also materially decreasing the possibility of obtaining an overall profit. We cannot fail to note also that, if the market had in fact reversed its course, the profit would have been in the short leg of the straddle instead of the long leg, and the long-term capital gains goal would not have been achieved. Thus, we can at least infer that the trading strategy was predicated on the assumption that the price of gold would continue to rise, petitioner's testimony to the contrary notwithstanding. Despite any residual or inherent profit motive

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more frequently in gold?

A. Well, I really didn't think I changed it that— You know, obviously, when you compare this — This is an unusual time that I'm doing this. In other words, World War III is almost to start. I mean, I'm in—they're just different from most of the others. I mean, the Iranian crisis, the Afghanistan crisis, gold is all at once making severe moves that it has never done historically. Interest rates are going out of sight. I'm making changes.

Obviously, the thing that I should have done is just reverse my position rather than to start hedging down. All of these moves are kind of hedges down. It's all hindsight now, but I should have completely reversed it, and then I would have made a substantial profit out of the thing.

[17] Greater weight is to be accorded objective facts than self-serving statements as to intent. *Siegel v. Commissioner*, 78 T.C. 659, 699 (1982).

petitioner may have had, the record here mandates our finding that petitioner's gold trades here in issue were primarily tax motivated. That is crystal clear on this record. It is not merely coincidental that the same tax straddle department which worked for petitioner, here, also effected the tax losses for the petitioners in *Smith v. Commissioner*, *supra*. And as we found in *Fox v. Commissioner*, *supra*, petitioner's tax motive was primary.

Having determined that under *Smith* and *Fox* we would find for respondent, the sole remaining issue, but the overriding one, is whether section 108 requires us to reach a different conclusion.[18] To the extent pertinent, section 108 provides as follows:

(a) GENERAL RULE.—For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions—

(1) which were entered into before 1982 and form part of a straddle, and

(2) to which the amendments made by title V of the Economic Recovery Tax Act of 1981 do not apply,

any loss from such disposition shall be allowed for the taxable year of the disposition if such position is part of a transaction entered into for profit.

(b) PRESUMPTION THAT TRANSACTION ENTERED INTO FOR PROFIT.—For purposes of subsection (a), any position held by a commodities dealer or any person regularly engaged in investing in regulated futures contracts shall be rebuttably presumed to be part of a transaction entered into for profit.

[Tax Reform Act of 1984, Pub. L. 98–369, sec. 108, 98 Stat. 630.]

The applicability of section 108 is clear. The losses in question were incurred during 1979 in the disposition of "1 or more positions" which were entered into in that year and to which the amendments made by title V of the Economic Recovery Tax Act of 1981 do not apply.[19] Thus, the losses incurred in petitioner's switches which took place in December 1979 are to be allowed for the year 1979 if each position which was so disposed of "is part of a transaction entered into for profit." Each position did form part of a straddle. Our decision turns on whether each straddle was a transaction entered into for profit.

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[18] In addition to the briefs of the parties, we have considered the brief amicus curiae of Dorchester Partners and Edward O. and Vivian S. Thorp filed by leave of the Court on Sept. 25, 1984. The arguments advanced in said brief were effectively presented by petitioners in this case and, therefore, will not be separately addressed in this opinion.

[19] This provision is effective as to transactions like those at issue here which were entered into after June 23, 1981.

That critical phrase—"transaction entered into for profit"—is identical with the language of section 165(c)(2). Respondent forcefully argues that this statutory language is unambiguous; hence the legislative history is immaterial and cannot be used, as petitioner urges, to alter the meaning of the phrase. However, respondent conveniently ignores the fact that in the two pertinent cases on which respondent would rely, *Smith v. Commissioner*, 78 T.C. 350 (1982) and *Fox v. Commissioner*, 82 T.C. 1001 (1984), this Court was forced to interpret this assertedly unambiguous section 165(c)(2) language—"transaction entered into for profit." Section 165(c)(2) does not tell us whether to use the taxpayer's subjective intent or some objective standard in applying the statute. Neither does it furnish guidance when the taxpayer is shown to have had more than a single motive. Thus, in *Fox* we established that it is the petitioner's primary motive to which we must look and that a merely incidental profit motive is immaterial. Our interpretation of this phrase in the section 165(c)(2) context demonstrates that it is sufficiently ambiguous to warrant our search for interpretative assistance. We simply cannot agree with respondent that we should ignore the legislative history accompanying section 108.[20] Respondent also argues that by using in section 108 the section 165(c)(2) verbiage, Congress must have intended identical interpretations. See, e.g., *Munson v. McGinnes*, 283 F.2d 333 (3d Cir. 1960), cert. denied 364 U.S. 880 (1960); *Bond Crown & Cork Co. v. Commissioner*, 19 T.C. 73 (1952). While that would be a persuasive argument in the absence of congressional guidance, we do have legislative history here.

Section 108 had no precise counterpart either in the House or the Senate versions of the bill; the only legislative history available is the Conference Committee report,[21] which in pertinent part reads as follows:

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[20] "Our obligation to look at legislative history is aptly stated in *J.C. Penney Co. v. Commissioner*, 37 T.C. 1013 (1962), affd. 312 F.2d 65 (2d Cir. 1962), where we said:

"Petitioner's contention that section 392 is clear and unambiguous is evidently aimed at preventing the Court from looking to the legislative history of that section and those related to it. * * * Furthermore, it is now established beyond successful challenge that a court may seek out any reliable evidence as to legislative purpose regardless of whether the statutory language appears to be clear. [37 T.C. at 1016, 1017. Citations omitted. See also *Huntsberry v. Commissioner*, 83 T.C. 742, 747–748 (1984).]"

[21] H. Rept. 98–861 (Conf.) (1984), 1984–3 C.B. (Vol. 2) 1, 171.

Accordingly, * * * the conference agreement provides that a loss on the disposition of a position entered into before 1982 will be allowed, except to the extent nonrecognition is required under any applicable provision, if the position is part of a transaction entered into for profit. * * * The loss generally will be allowed for the taxable years in which the position is disposed of. * * *

* * * In determining whether the position is part of a transaction entered into for profit, it is intended that the provision be applied by treating the condition as satisfied *if there is a reasonable prospect of any profit* from the transaction.

In the case of commodity dealers and persons actively engaged in investing in RFC's the provision is to be applied by presuming that the position is held as part of a transaction entered into for profit unless the Internal Revenue Service establishes to the contrary. In determining whether a taxpayer is actively engaged in trading in RFC's with an intent to make a profit, a significant factor will be the extent of transaction costs. If they are sufficiently high relatively to the scope of the taxpayer's activities that there is no reasonable possibility of a profit, the presumption will be unavailable. * * *

[Emphasis supplied.]

Section 108 was adopted after the submission of this case following extensive trial but prior to briefing. The parties have not called to our attention any case and we are unaware of any which under these circumstances would preclude the application of this new statute to the case at bar.[22] Respondent argues that application of section 108 to cases such as that of petitioner in a fashion which would preclude the application of our opinions in *Smith* and *Fox* would discriminate against those taxpayers who in deference to these cases had accepted respondent's limited settlement offers. That kind of discrimination, however, if it is to be so characterized, is a result of congressional action and both taxpayers and the Commission-

[22] With respect to subsec. (b) of sec. 108, the retroactive application of the presumption in favor of "any person regularly engaged in investing in regulated futures contracts" can pose at least theoretical difficulties. This case was tried without knowledge of this provision and therefore without specifically taking into account the presumption. Although neither party has sought to reopen the record, both parties argued this presumption issue on brief. Without belaboring the point, the transactions in issue here are regulated futures contracts and our findings make it appear that petitioner would be a person regularly engaged in investing in such contracts. On the other hand, it is far from clear that under respondent's temporary regulations (sec. 1.165-13T, Temporary Income Tax Regs.), petitioner would be so classified. The temporary regulations establish requirements which are not suggested either by the legislative language or committee report. However, in this case, this issue is moot. Both parties introduced extensive evidence, both documentary and oral testimony. Our findings of fact are based on the entire record, without reference to any presumption and the record is fully adequate to support them. We, therefore, express no opinion either on the temporary regulations in so far as they bear on this statutory presumption or on the availability of that presumption to petitioner in this case.

er must look to Congress for correction of the perceived inequity.

The narrow question before us is whether or not we are to apply to this case the test of *Smith* and *Fox* or must we interpret the phrase "transaction entered into for profit" on the basis of the legislative history of section 108—that is to allow losses on dispositions of positions if "there is a reasonable prospect of any profit from the transaction." Respondent seeks to rely on his section 108 temporary regulations[23] to bolster his arguments that petitioner's losses should be disallowed. Petitioner argues that these temporary regulations, as applied to this case, are invalid as they are directly contrary to the origin, purpose, and intent of section 108.

The applicable provisions are printed in Appendix B (p. 847 *infra*), but for practical purposes their essence is stated in the following extract from the preamble:

> The regulations state that section 108 of the Act does not change the standard for allowance of losses under section 165(c)(2) of existing law. In the case of straddles see *Fox v. Commissioner*, 82 T.C. No. 75 (1984) and *Smith v. Commissioner*, 78 T.C. 350 (1982). Under *Fox v. Commissioner*, a transaction is considered entered into for profit in the case of a straddle only if the taxpayer *entered into, and maintained, the transaction for the primary purpose of realizing an economic profit*. In addition, for section 108 of the Act to apply, the transaction must have sufficient substance to be recognized for federal income tax purposes.
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> The construction by the regulations that section 108 of the Act does not change the for-profit standard derives from the use in both that section [and section[24]] 165(c)(2) of the Code of the identical phrase "transaction entered into for profit." The continued utilization of the for-profit standard of section 165(c)(2) in section 108 of the Act reflects the Congressional purpose to provide certainty in the treatment of tax straddles entered into prior to ERTA.
>
> [Emphasis supplied.]

On brief, respondent insists that section 108 simply adopted existing law. He argues that the statute is not intended to grant amnesty to all pre-ERTA[25] straddles and, finally, if the legislative history is to be taken into account, respondent with considerable ingenuity interprets the phrase "reasonable pros-

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[23] Sec. 1.165-13T, Temporary Income Tax Regs., T.D. 7966, filed Aug. 21, 1984.

[24] These two words appear in the printed version of T.D. 7966, 1984-40 I.R.B. 4. They do not appear in the version in 49 Fed. Reg. 33444 (Aug. 23, 1984). It appears that the omission from the Federal Register is a typographical error.

[25] Economic Recovery Tax Act of 1981, Pub. L. 97-34, 95 Stat. 172.

pect of any profit" as imposing a more stringent test than section 165(c)(2). Thus respondent would interpret the Conference report to require "a significant potential to realize profits of a type normally sought by someone entering into a transaction for profit—profits of a size and magnitude attractive to a reasonable businessman." We simply do not agree.

The mere fact that section 108 uses the same verbiage as section 165(c)(2) does not require us to ignore its legislative history and interpret it as incorporating the section 165(c)(2) case law, i.e., *Smith* and *Fox*. While we might wish that Congress had made its collective intent clearer by use of more precise statutory language, we must, nevertheless, decide whether these temporary regulations harmonize not only with the plain language but also the *origin* and *purpose* of the statute. *United States v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982). For the reasons indicated herein, we find that the requisite harmony is lacking.

When testing a regulation, we apply well-established rules as set forth in our recent decision in *Stephenson Trust v. Commissioner*, 81 T.C. 283 (1983):[26]

> The Commissioner has broad authority to promulgate all needful regulations. Sec. 7805(a); *United States v. Correll*, 389 U.S. 299, 306–307 (1967). Treasury regulations "must be sustained unless unreasonable and plainly inconsistent with the revenue statutes." *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948). Regulations, as constructions of the Code by those charged with its administration, "should not be overruled except for weighty reasons." *Bingler v. Johnson*, 394 U.S. 741, 750 (1969); *Commissioner v. South Texas Lumber Co.*, *supra* at 501.
>
> Although regulations are entitled to considerable weight, "respondent may not usurp the authority of Congress by adding restrictions to a statute which are not there." *Estate of Boeshore v. Commissioner*, 78 T.C. 523, 527 (1982). See *State of Washington v. Commissioner*, 77 T.C. 656 (1981), affd. 692 F.2d 128 (D.C. Cir. 1982). A regulation is not a reasonable statutory interpretation unless it harmonizes with the plain language, origin, and purpose of the statute. *United States v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982); *Durbin Paper Stock Co. v. Commissioner*, 80 T.C. 252, 257 (1983).
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> [81 T.C. at 287–288.]

It is worth noting that these regulations were issued as temporary regulations because of the "need for immediate

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[26] We note that here as in *Stephenson Trust v. Commissioner*, 81 T.C. 283 (1983), the regulations were issued under the Commissioner's general power (sec. 7805) and are to be accorded less weight than legislative regulations. *Estate of Boeshore v. Commissioner*, 78 T.C. 523, 527 n. 5 (1982).

guidance." That need obviously involved a number of pending cases, including this one, where respondent was engaged in litigation over straddle losses. There is at least some question whether a regulation issued to buttress respondent's litigating position is entitled to any special presumption of validity. See, e.g., *Chock Full O'Nuts Corp. v. United States*, 453 F.2d 300, 303 (2d Cir. 1971). That aside, there appears to be little excuse for the temporary regulations except to try to avoid undercutting respondent's tax straddle litigating position, successfully achieved in *Smith* and *Fox*.

The legislative history makes it clear that Congress was aware of the Commissioner's litigating position on straddles and of our decision in *Smith v. Commissioner*, 78 T.C. 350 (1982). In that context, Congress did not wish "to prolong the uncertainty with respect to the treatment of losses claimed with respect to straddle positions for periods prior to 1981." If Congress had intended to legislate the results of our *Smith* and *Fox* decisions, it could very simply have made the ERTA rules retroactive or clearly embraced our decisions. It did neither. To the contrary, the Conference agreement "provides that a loss on the disposition of a position entered into before 1982 *will be allowed* * * * if the position is part of a transaction entered into for profit." (Emphasis supplied.) The Conference agreement goes on to define the term—transaction entered into for profit—by giving us the test "if there is a reasonable prospect of any profit." This is not the test of *Smith* as Congress well knew. And if respondent is correct in arguing that this legislation was also adopted with knowledge of *Fox*,[27] which we doubt, the section 108 test is certainly at the opposite end of the spectrum from the primary profit motive of *Fox*.

We hold that section 108 adopts an objective test and directs that losses be allowed on the disposition of a position if that particular straddle transaction can be said to have held "a reasonable prospect of any profit" at the time the straddle was acquired. The temporary regulations are plainly inconsistent with section 108 as so construed in accordance with its legislative history; the regulations insofar as they adopt the *Smith-Fox* test are invalid.

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[27] Mr. Rostenkowski submitted the Conference report on H.R. 4170 to the House of Representatives on Friday, June 22, 1984, whereas our opinion in *Fox* was filed on Monday, June 25, 1984.

To apply the objective test of section 108, we must first determine what was intended by the terms "transaction" and "position." Although not free from doubt, we believe that the term "transaction" should be deemed to refer to each separate straddle when, as here, that analysis is feasible. We recognize, however, that there may be circumstances where factually or otherwise it would be difficult or unduly burdensome to apply this straddle-by-straddle analysis. In those cases, the *Smith* approach provides an acceptable alternative. Under either alternative, the term "position" refers to one of the legs of each straddle. We are directed to apply section 108 when losses occur, that is, whenever during a year before us legs are disposed of and tax losses realized.[28] However, prior to analysis of the straddles in this case, one further aspect of straddle trading must be noted.

As we have found, substantially all commodity futures trading results in losses, but taxpayers continue to trade in the hope of making that "big killing," the proverbial goal of every gambler. If one were to judge commodity futures trading by customary business standards, one could conclude that no person trading in commodity futures contracts ever has a *reasonable* prospect of any profit. That simply cannot be the interpretation intended by the Conference agreement. As petitioner himself testified, there is a great similarity between oil and gas exploration and commodity futures trading. Dry holes may predominate but that is not to say that in no circumstances can it be said that an investor in oil and gas exploration does not have a "reasonable prospect of any profit."

Unquestionably, the use of the word "any" in this phrase was intended by Congress to have meaning. This is confirmed by the direction in the Conference agreement to compare the profit potential with the transaction costs. The phrase "any profit," therefore, requires some prospect for dollar gain over cash investment plus transaction costs. However, the profit potential need not equate with, relate to, or exceed some arbitrary percentage of the investment, whether investment is defined as the total initial margin, the aggregate margin cost,

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[28] Since a position is disposed of by the acquisition of the opposite position—one unit long January 1986 is disposed of by acquiring, i.e., selling, one unit short January 1986—this matching or offsetting position is to be ignored.

the face value of any single position acquired, or the aggregate face value of all the positions comprising the straddle determined as of the date acquired. Finally, whether or not the prospect of any profit is reasonable is tested on a facts and circumstances basis in the context of the futures market for the particular commodity at the time the trades are made.

Thus, the final question to ask is whether the particular straddles here involved had a reasonable prospect of any profit in the then-existing market. On this record, we simply cannot determine whether the prospect for a profit from these straddles in a rising market was a reasonable one. If, however, the market had reversed its course, one of respondent's experts is in agreement with petitioner's expert that profits were foreseeable from these straddles.[29] There is every reason to believe, as we do, that each of the straddles to be tested here had, when acquired, a reasonable prospect for profit and there is no evidence to the contrary. Speculation in commodity futures was not an exact science in 1979. The pertinent facts and circumstances support our conclusion. The section 108 requirements are met.

Respondent, on the authority of *Knetsch v. United States*, 364 U.S. 361 (1960), and similar cases, including our decision in *Hilton v. Commissioner*, 74 T.C. 305 (1980), affd. 671 F.2d 316 (9th Cir. 1982), cert. denied 459 U.S. 907 (1982), further argues that there is no economic substance, or at best, minimal economic substance, to petitioner's gold trades; hence the losses must be disallowed notwithstanding section 108. We again disagree. There is force to the opinions of respondent's experts that there was no real economic substance to the gold straddle switches, meaning that petitioner's economic position was not altered materially thereby. Respondent's experts also testified that the reward or profit potential in these straddles was insufficient to attract a profit-motivated person. Hence an individual, intending to speculate in commodity futures for profit, probably would not have made these trades. We do not disagree. Tax losses, not economic profit, motivated petitioner.

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[29] Dr. Roger Gray, one of respondent's expert economists, testified that during the October 1979—April 1980 period, opinion was split as to the direction which gold futures prices would take. Hence a straddle investment strategy predicated on the assumption that prices would decline was reasonable. Dr. Gray described petitioner's prospect for profits in a declining market as "modest." Respondent's second expert testified, as did other witnesses, that the switches reduced the profit potential. That at least implies the possibility of some profit.

However, the short answer to this argument is that both section 108 and *Smith* preclude respondent's application of the economic substance test. For section 108 purposes, it does not matter at all that petitioner was arguably in neither a better nor a worse economic position after each of the December 1979 switches. If it does anything, respondent by this argument merely reinforces our conclusion that each new straddle continued to have substantially the same reasonable prospect of profit as did the original straddle. Answer 2 of section 1.165–13T of the temporary regulations provides in pertinent part as follows:[30]

> Moreover, in order for section 108 of the Act to apply, the transaction must have sufficient substance to be recognized for Federal income tax purposes. Thus, for example, since a "sham" transaction would not be recognized for tax purposes, section 108 of the act would not apply to such a transaction.

It is not clear from these regulations how respondent defines a transaction with "sufficient substance" so that the transaction would be recognized for Federal income tax purposes. Such language could be construed as adopting the economic substance theory of *Knetsch v. United States*, *supra*, or as merely adopting the factual sham test of *Julien v. Commissioner*, 82 T.C. 492 (1984), or both. If respondent intended this language to adopt the economic substance theory, it would be inconsistent with section 108 which it purports to interpret. If it merely describes the factual sham test, there is no inconsistency. Section 108 applies only to straddles actually acquired by a taxpayer during the pre-1982 period. If the alleged straddles are in fact fake or fictitious, we would not reach the question of the application of section 108.

When there are at least two constructions of ambiguous language in a regulation, one of which is consistent and one inconsistent with the statute, the regulations should be upheld by adopting that interpretation of the language which is consistent with the intent underlying the statute. *United Telecommunications, Inc. v. Commissioner*, 589 F.2d 1383, 1390 (10th Cir. 1978), affg. 65 T.C. 278 (1975), cert. denied 442 U.S. 917 (1979); *Landerman v. Commissioner*, 454 F.2d 338, 342 (7th Cir. 1971), affg. 54 T.C. 1042 (1970), cert. denied 406 U.S. 967

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[30] The complete version of answer 2 of sec. 1.165–13T of the temporary regulations is printed in Appendix B.

(1972), rehearing denied 409 U.S. 903 (1972); see also *Emery Mining Corp. v. Secretary of Labor*, 744 F.2d 1411, 1414 (10th Cir. 1984).[31] Hence, we must interpret the temporary regulations to refer only to factual shams.

Applying section 108 to this record, we conclude that the losses realized on December 3 and 4, 1979, in which the December 1980 short gold position was disposed of are allowable. The new straddle acquired on those dates—15 August 1980 long, 15 October 1980 short—must be tested since on December 13, 1979, petitioner disposed of the 15 October 1980 short position and realized a further loss. Again, and although petitioner concedes that his profit potential was narrowed, there was a reasonable prospect of profit from this straddle. That loss is allowable.[32]

On these facts, we are constrained by section 108 to find for petitioner notwithstanding the fact that this result is directly contrary to our holdings in *Smith* and *Fox*. It is not, however, for this Court to question the wisdom of the congressional mandate.

Due to concessions made by each party, decision will be entered under Rule 155.

Reviewed by the Court.

FAY, STERRETT, GOFFE, WILBUR, NIMS, KÖRNER, HAMBLEN, COHEN, and CLAPP, *JJ.*, agree with the majority opinion.

GERBER, *J.*, did not participate in the consideration of this case.

APPENDIX A

Appendix A appears on pages 848 and 849.

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[31] An appeal in this case would be to the 10th Circuit.

[32] The new butterfly straddle acquired on Dec. 13, 1979, composed of 5 June 1980, 15 August 1980, and 10 December 1980, is not required to be tested in this case since the switch realizing a loss occurred in 1980. However, on the record before us, it is not inappropriate to note that the profit circumstances for this straddle do not appear to differ substantially from petitioner's two other gold straddles discussed in the text.

APPENDIX B

Temporary Income Tax Regulations (1.165–13T) relating to straddles entered into before the effective date of the Economic Recovery Tax Act of 1981.

The following questions and answers concern the treatment of losses on certain straddle transactions entered into before the effective date of the Economic Recovery Tax Act of 1981, under the Tax Reform Act of 1984 (98 Stat. 494).

Q-1 What is the scope of section 108 of the Tax Reform Act of 1984 (Act)?

A-1 Section 108 of the Act provides that in the case of any disposition of one or more positions, which were entered into before 1982 and form part of a straddle, and to which the provisions of Title V of The Economic Recovery Act of 1980 (ERTA) do not apply, any loss from such disposition shall be allowed for the taxable year of the disposition if such position is part of a transaction entered into for profit. For purposes of section 108 of the Act, the term "straddle" has the meaning given to such term by section 1092(c) of the Internal Revenue Code of 1954 as in effect on the day after the date of enactment of ERTA; including a straddle all the positions of which are regulated futures contracts (as defined in Q&A-6 of this section). Straddles in certain listed stock options were not covered by ERTA and are not affected by this provision.

Q-2 What transactions are considered entered into for profit?

A-2 A transaction is considered entered into for profit if the transaction is entered into for profit within the meaning of section 165(c)(2) of the Code. In this respect, section 108 of the Act restates existing law applicable to straddle transactions. All the circumstances surrounding the transaction, including the magnitude and timing for entry into, and disposition of, the positions comprising the transaction are relevant in making the determination whether a transaction is considered entered into for profit. Moreover, in order for section 108 of the Act to apply, the transaction must have sufficient substance to be recognized for Federal income tax purposes. Thus, for example, since a "sham" transaction would not be recognized for tax purposes, section 108 of the act would not apply to such a transaction.

APPENDIX A

CHART V

GILBERT R. MILLER
GOLD COMMODITY TRANSACTIONS
1979 THROUGH 1980

	Contracts				Current balance long/(short)	Gain (loss) claimed on tax return (1)	Calculated unrealized gain (loss) date	Unrealized gain (loss) in account	Net equity in account (2)
	June 80	Aug. 80	Oct. 80	Dec. 80					
					1979 Transactions				
Initial transaction									
10/19/79									
Trade		15		(15)					
Position		15		(15)	15–(15)	N/A		150	(1,845.00)
First Transaction									
12/3/79									
Trade		—	(7)	7					
Position		15	(7)	(8)	15–(15)	(22,340.50)	12/3/79	21,820	(2,515.50)
Second transaction									
12/4/79									
Trade		—	(8)	8					
Position		15	(15)	0	15–(15)	(24,012.00) (46,352.50)	12/4/79	36,960	(11,387.50)
Third transaction									
12/13/79									
Trade	(5)	—	15	(10)					
Position	(5)	15	0	(10)	15–(15)	(56,972.50) (103,325.00)	12/13/79	99,100	(6,220.00)

	Contracts				Current balance long/(short)	Gain (loss) claimed on tax return [1]	Calculated unrealized gain (loss) date	Unrealized gain (loss) in account	Net equity in account [2]
	June 80	Aug. 80	Oct. 80	Dec. 80					
					1980 Transactions				
Fourth transaction									
3/7/80									
Trade	(5)			5					
Position	(10)	15	0	(5)	15–(15)	(80,207.50)			
						(183,532.50)	3/7/80	159,750	(25,777.50)
Final transaction									
4/21/80									
Trade	10	(15)		5					
Position	0	0	0	0	0–(0)	157,905.00			
						(25,627.50)	4/21/80		[1](25,627.50)

[1]Represents total loss on Gold Transactions—includes $3,447.50 in Commissions and Fees paid.
[2]Includes amounts of commission required to close all positions.

NIMS, *J.*, concurring: I agree with and have joined the majority opinion because I think it correctly and accurately expresses the intent of Congress in the enactment of section 108 of the Tax Reform Act of 1984. I write only to respond to the dissenting opinions filed by Chief Judge Dawson and Judge Simpson.

It was my privilege to express the unanimous views of this Court in *Smith v. Commissioner*, 78 T.C. 350 (1982), where we held, on facts very similar to those now before us, that the taxpayers lacked the requisite profit motive under section 165(c)(2), I.R.C. 1954. That is not to say, however, that there was no reasonable prospect of any profit, small though it might have been. In its report, the Conference Committee expressed its awareness of *Smith*, but as is manifest from the language of the report, the Conference Committee chose to change the test in straddle cases from profit motive to profit potential; i.e., from a subjective to an objective test. In doing so, they unequivocally stated that a reasonable prospect of *any* profit suffices.

If the practical effect in honoring the clearly expressed will of Congress is to grant amnesty to pre-1981 commodity tax straddlers, so be it. It is certainly not the proper function of this or any other Court to subvert the will of Congress by substituting the personal preferences of the Judges, and the majority prudently has not done so.

WILBUR, WHITAKER, HAMBLEN and COHEN, *JJ.*, agree with this concurring opinion.

SIMPSON, *J.*, dissenting: The real significance of the issue to be decided by the Court today can be illustrated by figures contained in the congressional debate: reportedly, notices of deficiency have been issued in 15,000 cases involving tax straddles and deficiencies of $1.5 billion. 11 Cong. Rec. S8390 (daily ed. June 27, 1984), and 12 Cong. Rec. E3251–E3252 (daily ed. July 24, 1984). By the enactment of section 108 of the Tax Reform Act of 1984, Congress has clearly indicated that tax relief is to be extended to dealers in tax straddles at a cost of over $300 million in revenue. Based, not on the words of the statute but on a vague sentence in the Conference Committee report, the majority of this Court has decided to interpret

section 108 so as to extend the tax relief to all traders in tax straddles with a cost of $1.5 billion in revenue. These figures illustrate why, as a court, we should not depart from the well-established meaning of the phrase "transaction entered into for profit" without a clear direction by the Congress to do so, and why I must dissent.

Section 108 provides that any loss from the disposition of a position forming part of a straddle entered into before 1982, and to which the amendments made by title V of the Economic Recovery Tax Act of 1981 (ERTA) do not apply, "shall be allowed for the taxable year of the disposition *if such position is part of a transaction entered into for profit.*" (Emphasis added.) The requirement that the loss position be part of a transaction entered into for profit is identical in phraseology to the requirement of section 165(c)(2), which permits an individual to deduct losses "incurred in any transaction entered into for profit." Contrary to the implication contained in the majority opinion at page 838, we were not "forced to interpret this assertedly unambiguous section 165(c)(2) language" for the first time in *Smith v. Commissioner*, 78 T.C. 350 (1982), and *Fox v. Commissioner*, 82 T.C. 1001 (1984); rather, in those cases, we relied on long-established precedent in holding that a "transaction entered into for profit" is, for purposes of section 165(c)(2), a transaction entered into with the predominant or primary hope of deriving an economic profit aside from tax benefits. As we observed in *Fox v. Commissioner*, *supra* at 1019–1020, the "primary purpose" test first appeared as a judicial gloss on the statutory language of section 165(c)(2) in *Helvering v. National Grocery Co.*, 304 U.S. 282 (1938), where the Supreme Court stated in a footnote that "the deductibility of losses under section 23(e) [the predecessor of section 165(c)(2)] * * * may depend upon whether the taxpayer's motive in entering into the transaction was primarily profit." 304 U.S. at 289 n. 5. The subjective, primary purpose test has since been adopted as the standard to be applied in determining whether a transaction is "entered into for profit" in cases arising under section 165(c)(2) and its predecessor, section 23(e). *King v. United States*, 545 F.2d 700, 708 (10th Cir. 1976); *Austin v. Commissioner*, 298 F.2d 583, 584 (2d Cir. 1962), affg. 35 T.C. 221 (1960); *Knetsch v. United States*, 172 Ct. Cl. 378, 348 F.2d 932, 936 (1965); *Ewing v. Commissioner*, 20 T.C.

216, 233 (1953), affd. 213 F.2d 438 (2d Cir. 1954). Moreover, essentially the same standard has been adopted in determining when an activity is "not engaged in for profit" for purposes of section 183 (sec. 1.183–2(a), Income Tax Regs.; *Fox v. Commissioner*, 80 T.C. 972 (1983), affd. by order 742 F.2d 1441 (2d Cir. 1984), affd. sub nom. *Barnard v. Commissioner*, 731 F.2d 230 (4th Cir. 1984), affd. without published opinions sub nom. *Hook v. Commissioner*, *Kratsa v. Commissioner*, *Leffel v. Commissioner*, *Rosenblatt v. Commissioner*, *Zemel v. Commissioner*, 734 F.2d 5–7, 9 (3d Cir. 1984)), and whether a taxpayer is "carrying on any trade or business" under section 162 or is holding property "for the production of income" under section 212 (*Hager v. Commissioner*, 76 T.C. 759 (1981); *Lemmen v. Commissioner*, 77 T.C. 1326 (1981)).

In light of these cases, when Congress used the phrase "transaction entered into for profit" in section 108, its well-established meaning must have been evident to those working with the statute. We must presume that Congress intended such phrase to have the same meaning when used in section 108. *Helvering v. Stockholms Enskilda Bank*, 293 U.S. 84, 87 (1934). Even so, it is still appropriate to examine the legislative history for further evidence of the legislative purposes. *United States v. American Trucking Associations*, 310 U.S. 534, 543–544 (1940). "Nevertheless, where a statute is clear on its face, we would require *unequivocal evidence* of legislative purpose before construing the statute so as to override the plain meaning of the words used therein." *Huntsberry v. Commissioner*, 83 T.C. 742, 747–748 (1984) (emphasis added).

In explanation of the purposes of section 108, the Statement of the Managers provides in relevant part:

> The conferees believe it is inappropriate to prolong the uncertainty with respect to the treatment of losses claimed with respect to straddle positions for periods prior to 1981. Accordingly, in lieu of the Senate amendment's requirement of a report with respect to pre-1981 cases, the conference agreement provides that a loss on the disposition of a position entered into before 1982 will be allowed, except to the extent nonrecognition is required under any applicable provision, if the position is part of a transaction entered into for profit. This treatment applies where the position is part of a straddle as defined in section 1092 as in effect on the day after the date of enactment of ERTA (as well as a straddle consisting entirely of RFCs), and is one to which the provisions of Title V of ERTA did not apply. The loss generally will be allowed for the taxable years in which the position is

disposed of. Rules affecting the period within which the loss is recognized, and its treatment as long-term or short-term, such as sec. 1233 or sec. 1234, are to be applied without regard to the fact that the position is part of a straddle.

* * * In determining whether the position is part of a transaction entered into for profit, it is intended that the provision be applied by treating the condition as satisfied if there is a reasonable prospect of any profit from the transaction.

In the case of commodity dealers and persons actively engaged in investing in RFCs, the provision is to be applied by presuming that the position is held as part of a transaction entered into for profit unless the Internal Revenue Service establishes to the contrary. In determining whether a taxpayer is actively engaged in trading in RFCs with an intent to make a profit, a significant factor will be the extent of transaction costs. If they are sufficiently high relatively to the scope of the taxpayer's activities that there is no reasonable possibility of a profit, the presumption will be unavailable.

* * *

[H. Rept. 98–861 (1984), 1984–3 C.B. (Vol. 2) 1, 171.]

The statement reveals that Congress wishes to put an end to the litigation over tax straddles, and to accomplish that end, it adopted two new statutory rules: (1) It rejected the Commissioner's position and provided that the disposition of a loss leg of a straddle constitutes a closed and completed transaction for purposes of section 165(c)(2); and (2) it establishes a rebuttable presumption that any position held by a commodities dealer or any person regularly engaged in investing in regulated futures contracts is part of a transaction entered into for profit. However, there is no clear indication that Congress intended any other changes in pre-ERTA law with respect to straddles. The Conference Committee report does not express dissatisfaction with our decision in *Smith v. Commissioner*, *supra*; in fact, the committee adopted our conclusion in that case that the disposition of a loss leg is a taxable event. While the committee also adopted a presumption in favor of commodity dealers, it did not expressly overrule our application in *Smith* of the traditional subjective test of primary purpose, insofar as it was applied to "investors with isolated [commodity futures] transactions."

The majority focuses on the phrase "reasonable prospect of any profit" and concludes that such language establishes a new "for profit" test. The majority first examines the words "any profit" and says "The phrase 'any profit,' therefore, requires some prospect for dollar gain over cash investment

plus transaction costs." In connection with "reasonable prospect," the majority states at page 844:

> Finally, whether or not the prospect of any profit is reasonable is tested on a facts and circumstances basis in the context of the futures market for the particular commodity at the time the trades are made.
>
> * * * On this record we simply cannot determine whether the prospect for a profit from these straddles in a rising market was a reasonable one. If, however, the market had reversed its course, one of respondent's experts is in agreement with petitioner's expert that profits were foreseeable from these straddles. There is every reason to believe, as we do, that each of the straddles to be tested here had when acquired a reasonable prospect for profit and there is no evidence to the contrary. * * * [Fn. ref. omitted.]

The majority had already concluded that the petitioner's trading strategy was predicated on an assumption that the gold market would rise; yet, the majority declined to inquire as to whether, in such a market, the prospect of profit would be reasonable. Since some experts expected the market to fall, there was the possibility of a profit, and apparently, that possibility was sufficient to convince the majority that there was a "reasonable prospect" of a profit.

Such interpretation is not compelling. The dictionary defines "prospect" as an "act of looking forward; anticipation, foresight." Webster's Third New International Dictionary (1981). Yet, in the statute, "prospect" is modified by "reasonable." It is not enough to anticipate or foresee some profit; that anticipation must be reasonable. We cannot determine the reasonableness of a prospect without some inquiry into the likelihood that it will occur. Can we say that a prospect is reasonable when the petitioner, an experienced trader in commodity futures, his Merrill Lynch advisers, and many market experts expected that it would not occur? The use of "reasonable" reveals that Congress had in mind more than the mere possibility; an unlikely possibility cannot be said to be reasonable. It appears that the majority has totally ignored the requirement of "reasonable" in its interpretation.

Furthermore, if the majority's interpretation is adopted, the presumption contained in section 108(b), which was enacted to provide special relief to dealers in tax straddles, is unnecessary. In virtually every tax straddle, there will exist the possibility of a profit, and therefore, under the majority's interpretation, all traders in tax straddles will receive tax

relief, thereby eliminating the need for a presumption in favor of dealers. In addition, if we conclude that Congress meant to reject the definition of the "for profit" test in *Smith* and *Fox*, other broad and significant questions arise: Is this new "for profit" test to be applied henceforth under section 165(c)(2), and is the new test to be applied for purposes of sections 162, 183, and 212? Surely, if Congress intended to adopt a new provision of law with such broad and pervasive effect, it would have done so in a more conspicuous manner.

Aside from the Statement of the Managers in the Conference Committee report, the managers of the legislation, Chairman Rostenkowski of the Ways and Means Committee and Senator Dole, Chairman of the Finance Committee, offered no further explanation of the scope or effect of section 108. However, Senator Howard Metzenbaum, of Ohio, spoke out about section 108:

> the effect of that provision is virtually to preclude the IRS from pursuing tax cases against about 200 traders of commodity futures for an estimated $300 million in taxes that the IRS is trying to collect from traders who used the now outlawed tax avoidance scheme known as a commodity straddle.
>
> As a matter of fact, the IRS preliminary data indicates that there are 4,400 cases presently pending in [the] Tax Court representing $500 million in taxes before interest is assessed. The IRS has assessed deficiencies for 15,000 taxpayers for $1.5 billion. There is no data on how many professional traders are involved, but we do know that whether it is $300 million or $500 million or a substantial amount more, the commodity traders and dealers were well taken care of in the conference committee * * *
>
> [11 Cong. Rec. S8390 (daily ed. June 27, 1984).]

Similarly, Richard L. Ottinger, a Representative from New York, stated on July 24, 1984, that "This tax break [provided by section 108] has been afforded to 200 or so commodity traders in Chicago at a cost of $300 million to the Government." 12 Cong. Rec. E3251 (daily ed. July 24, 1984). Mr. Ottinger also inserted into the Congressional Record an article from the Washington Post of July 2, 1984, in which the author stated that:

> Rostenkowski's bailout means that two taxpayers who arranged virtually identical commodity deals to avoid paying taxes will be treated differently.
>
> Ordinary investors will have to show they were trying to make money, not simply create losses to claim as tax deductions. But thanks to Rostenkowski, "professional commodity traders and persons who regularly trade commodity futures contracts" will be presumed to have a profit motive.

> In many cases that distinction will mean the brokers who invented this tax dodge will get away with using it, but their clients will have to pay taxes. [12 Cong. Rec. E3251 (daily ed. July 24, 1984).]

These statements by Senator Metzenbaum and Representative Ottinger do reflect the contemporaneous understanding of what Congress was doing by the enactment of section 108. Congress realized that it was extending substantial tax relief to dealers in tax straddles, but these statements make it indisputably clear that Congress had no understanding that it was granting tax relief to all traders in tax straddles with a consequent loss in revenue exceeding $1.5 billion. The outcry by the critics of the legislation would, no doubt, have been substantially greater had they understood that the legislation was extending tax relief to all traders of tax straddles.

Nearly 100 years ago, the Supreme Court observed:

> These cases show the principle upon which is founded the rule that a claim for exemption from taxation must be clearly made out. Taxes being the sole means by which sovereignties can maintain their existence, any claim on the part of any one to be exempt from the full payment of his share of taxes on any portion of his property must on that account be clearly defined and founded upon plain language. There must be no doubt or ambiguity in the language used upon which the claim to the exemption is founded. It has been said that a well founded doubt is fatal to the claim; no implication will be indulged in for the purpose of construing the language used as giving the claim for exemption, where such claim is not founded upon the plain and clearly expressed intention of the taxing power. [*Bank of Commerce v. Tennessee*, 161 U.S. 134, 146 (1896).]

Over the intervening years, this proposition has been repeatedly embraced and applied by the Supreme Court. *Bingler v. Johnson*, 394 U.S. 741, 751–752 (1969); *Commissioner v. Jacobson*, 336 U.S. 28, 48–49 (1949); *United States v. Stewart*, 311 U.S. 60, 71 (1940); *Helvering v. Northwest Steel Mills*, 311 U.S. 46, 49 (1940); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934). Here, a trader in tax straddles urges us to construe section 108 so as to allow a deduction for his losses; to allow such losses, we must find that Congress intended by the "reasonable prospect of any profit" sentence to change the well-established meaning of the "for profit" test. In my judgment, that sentence, at most, casts some doubt on the intention of Congress; it certainly does not unequivocally manifest an intention to change the law. Under such circum-

stances, long-established principles of statutory construction should require us to conclude that the traditional "for profit" test is to be applied in this case and that the petitioner is not entitled to deduct his losses.

DAWSON, CHABOT, PARKER, SHIELDS, SWIFT, JACOBS, and WRIGHT, *JJ.*, agree with this dissent.

DAWSON, *Chief Judge*, dissenting: I fully agree with Judge Simpson's dissenting opinion. But I have other thoughts and comments.

This case is a prime example of why simplification and reform of our Federal income tax laws are needed.[1] It is also a prime example of unfairness and creates further horizontal and vertical inequities.

If my analysis of the majority opinion is correct, I think the implications of the opinion are startling and wrong. If, as the majority concludes, the scope of section 108 of the Tax Reform Act of 1984 was intended to grant amnesty to all pre-ERTA commodity straddles, then perhaps Mr. Bumble was right.[2] However, I firmly believe that Congress did not intend for section 108 to encompass all pre-ERTA commodity straddles. I am unwilling to attribute such an intent to the conferees of the tax-writing committees and to the members of Congress. The conclusion of the majority here represents a sharp departure from the principle of judicial restraint by relying on murky and gratuitous legislative history which flies in the face of the plain language of the statute. I think we should stay our hand and apply section 108 only to its intended recipients—commodity dealers. By expanding that section beyond its reasonable scope, the majority is basically rewriting the statute. I would refrain from such judicial legislation in the absence of *unequivocal evidence* of legislative purpose to the contrary. The majority's strained construction of section 108 will impede

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[1] In his radio address on Apr. 13, 1985, the President said the Federal tax system is "a complicated, frustrating, unfair mystery of legalistic gobbledygook and loopholes never designed, it seems, to help everyday wage earners, only those who can afford high-priced attorneys and accountants." To that I would add: Simplification and reform of the Federal tax system are long overdue.

[2] "If the law supposes that," said Mr. Bumble * * * "the law is a ass, a idiot." C. Dickens, Oliver Twist, ch. 51.

the countdown for abusive tax shelters. The result, as I see it, is tax shelter relief run riot.

It is inconceivable to me that, in the Tax Reform Act of 1984, Congress would provide the Internal Revenue Service with new and strong enforcement tools to crack down on abusive tax shelters,[3] and in the same law provide expansive tax relief for all investors in pre-ERTA commodity straddles. Congress also indicated that it expects the Tax Court to impose "without hesitancy in appropriate circumstances the penalties that Congress has provided." See Staff of Joint Comm. on Taxation, General Explanation of Revenue Provisions of the Deficit Reduction Act of 1984, at 485 (Comm. Print 1984). In view of its positive legislative actions to curb the use of abusive tax shelters, I do not believe Congress intended to permit taxpayers, like the petitioner, to reap tax bonanzas with flaky deals that are tax motivated rather than economically motivated.

I dissent because, in my judgment, the majority has chosen a wrong and tortuous path.

CHABOT, PARKER, SHIELDS, SWIFT, and WRIGHT, *JJ.*, agree with this dissent.

SWIFT, *J.*, dissenting: The majority opinion holds that losses realized in a straddle transaction will qualify as short-term losses so long as "it can be said" that the transaction offered a prospect of a nominal profit and even though the individual investor entered into the transaction not because of that prospect of a nominal profit but only for the likely tax losses to be generated therefrom. Under this test, an individual investor's motive in entering into a particular straddle transaction is rendered irrelevant and immaterial. This change in the law (which focuses on what *may* occur in the marketplace to *any* investor and which disregards the specific motive of the individual investor who entered into the particular transac-

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[3] See, for example, the following compliance provisions of the Tax Reform Act of 1984 with respect to tax shelters: (1) Sec. 141 relating to the registration of tax shelters; (2) sec. 142 requiring promoter lists; (3) sec. 143 increasing the penalty for promoting abusive tax shelters and providing for injunctions against aiding and abetting the understatement of tax liability; and (4) sec. 144 increasing the rate of interest for tax-motivated transactions. It is significant that a "tax motivated transaction" includes "any straddle." The majority opinion in this case acknowledges that "petitioner's gold trades here in issue were primarily tax motivated."

tion in question) is directly contrary to the express language of section 108 and, in my opinion, is incorrect.

As we recently stated—

> The starting point for interpreting a statute is the language of the statute itself. E.g., *Rosewell v. LaSalle National Bank*, 450 U.S. 503, 512 (1981); *Consumer Product Safety Commission v. GTE Sylvania*, 447 U.S. 102, 108 (1980). Absent a clearly expressed legislative intention to the contrary, the language of a statute ordinarily must be regarded as conclusive. E.g., *United States v. Turkette*, 452 U.S. 576, 580 (1981); *Consumer Product Safety Commission v. GTE Sylvania, supra* at 108. * * * [*Tamarisk Country Club v. Commissioner*, 84 T.C. 756 (1985).]

Thus, in considering herein the interpretation and significance to be given the relevant language from the Conference Committee report, the question should be asked whether the apparent focus of that language on what may happen in the marketplace (as distinct from the focus of the statutory language on the individual investor's specific motive in entering into a particular straddle transaction) represents such a significant departure from the statutory language that the language of the Conference Committee report must be disregarded absent a clearer and unequivocal statement from Congress that that departure was intended.

For the reasons set forth herein, and in the dissenting opinions of Chief Judge Dawson and Judge Simpson, I respectfully dissent.

DAWSON, CHABOT, PARKER, and SHIELDS, *JJ.*, agree with this dissent.

BRETT GRAHAM BALDWIN, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 14363–82. Filed May 15, 1985.

Amounts received from the Social Security Administration as survivor benefits constitute "support" payments provided by the Federal Government and not by the taxpayer-recipient for

purposes of the income averaging provisions of sec. 1303 (c)(1), I.R.C. 1954.

Kathryn J. Sedo and Daniel W. McDonald, for the petitioner.

Genelle F. Forsberg and *Gerald W. Leland*, for the respondent.

SWIFT, *Judge*: In a statutory notice dated April 6, 1982, respondent determined a deficiency in petitioner's 1979 tax liability, and additions to tax, as follows:

	Additions to tax		
Deficiency	*Sec. 6651(a)*	*Sec. 6653(a)*	*Sec. 6654(a)*
$3,363	$840.75	$168.15	$140.97

Following concessions, the primary issue remaining for decision is whether petitioner provided at least one-half of his support during the years 1975 through 1978, thereby allowing him to properly compute his Federal income tax liability pursuant to the income averaging provisions set forth in sections 1301 through 1305.[1] The resolution of this issue turns upon whether petitioner may properly treat amounts received as survivor's benefits from the Social Security Administration and the Veterans' Administration due to the death of his father as financial support that petitioner provided to himself. Respondent contends that these amounts cannot properly be treated as amounts contributed by petitioner, but are amounts received from independent sources.

Petitioner also argues that certain aspects of the income averaging provisions are unconstitutional. Also at issue herein are the additions to tax determined by respondent under sections 6651(a) (failure to file), 6653(a) (negligence), and 6654(a) (underpayment of estimated tax liability).

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The pertinent facts are summarized below.

The petitioner, Brett Graham Baldwin, was a resident of Scottsdale, Arizona, at the time the petition herein was filed.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as in effect during the year in issue.

Petitioner claims to have timely filed a so-called "fifth amendment return" for 1979, although respondent has no record of such a filing. Petitioner stated that he filed such a return upon the recommendation of a local "tax protester" group in Arizona, that he did so without checking the relevant legal authorities, and that he now regrets not having done more research into the truth of the group's claims before filing such a "return."

A letter dated January 28, 1982, was sent by respondent, advising petitioner that he may be subject to civil and criminal additions and penalties for failing to file a 1979 return. Following the issue of the statutory notice herein and of an additional letter from respondent dated April 18, 1983, petitioner filed a completed 1979 Federal income tax return on or about April 12, 1983.

From 1975 to the summer of 1978, petitioner was a full-time student at Arizona State University in Tempe, Arizona. Petitioner graduated from Arizona State in December 1978, with a bachelor of science degree in electrical engineering. At that time he was 21 years of age. Petitioner started working at a full-time job sometime in 1978, apparently prior to graduation.

Petitioner had no taxable income in 1975 and therefore did not file a Federal income tax return that year. He did file timely individual Federal income tax returns for the years 1976, 1977, and 1978. The returns filed with respect to the years 1976 and 1977 reported zero tax liability. The 1978 return reflected a Federal income tax liability of $66.

During the years 1975 through 1978, petitioner's sole sources of support were academic scholarships from Arizona State University, Basic Educational Opportunity Grants (hereinafter referred to as BEOG), Supplemental Educational Opportunity Grants (hereinafter referred to as SEOG), National Defense Student Loans (hereinafter referred to as NDSL), Social Security survivor's benefits, Veterans' Administration survivor benefits, and wages received from Arizona State University's work-study program. In the latter part of 1978, petitioner also received wages from his full-time employment.

All funds received by petitioner were nontaxable receipts to him except the wages received from the work-study program and from his full-time job which started in 1978. The BEOG and

SEOG funds were nontaxable educational grants similar to a scholarship. The NDSL funds were loans that petitioner was required to repay. The total amounts received by petitioner from each of the above sources is set forth below:

Source	*1975*	*1976*	*1977*	*1978*
Social Security Administration	$1,477	$1,818	$2,098	$1,848
Veterans' Administration	144	324	348	256
Scholarships (ASU)	200	425	450	225
BEOG	612	975	807	313
SEOG	0	400	1,200	300
NDSL	0	100	322	822
Wages—Work-study	0	550	210	240
Wages—Full-time job	0	0	0	4,323
Total "support"	$2,433	$4,592	$5,435	$8,327

On his 1979 Federal income tax return, petitioner reported that he had wage income in the amount of $18,431.92, interest income of $86, moving expenses of $893, and employee business expenses of $854. The deductions have not been questioned by respondent and are not in issue. Petitioner was single and had no dependents throughout the years 1975 through 1979.

The parties have stipulated that: (1) The amounts set forth above constitute petitioner's total amounts of "support" during the years 1975–79, and that they were actually expended for that purpose; (2) petitioner provided over one-half of his own support for 1978 from his wage income; (3) the amounts received as academic scholarships and educational grants constitute amounts of support that petitioner did not provide for himself; and (4) that amounts received as wages and loans constitute amounts that petitioner did provide for his own support.

OPINION

The major dispute in this case concerns whether amounts received by petitioner from the Social Security Administration and from the Veterans' Administration as survivor's benefits constitute support provided by petitioner to himself. If, as petitioner argues, such payments qualify as support provided by himself, he may compute his income tax liability for 1979 pursuant to the income averaging provisions in sections 1301

through 1305. If either the amounts received from the Social Security Administration or the Veterans' Administration constitute amounts of support not contributed by petitioner, he will be ineligible for income averaging with respect to 1979.

Section 1303(c)(1) provides that an individual shall not be eligible for income averaging if, for any base year,[2] such individual (and his spouse, if applicable) furnished less than one-half of his support.[3] There are three exceptions to this rule provided in section 1303(c)(2), none of which applies to petitioner herein.[4]

The social security payments in issue herein were authorized pursuant to the provisions of 42 U.S.C. sec. 402(d) et seq. (1983). Such payments were made to petitioner because of his status as a child of an individual (namely, his father) who died a "fully insured" individual under the social security system, and the fact that petitioner was a full-time student under the age of 22 during the years 1975 through 1979. The payments were calculated as a certain percentage of the insured individual's "primary insurance amount." See 42 U.S.C. sec. 402(d)(2) (1983).

The legislative history of the 1965 amendments to the Social Security Act, which amendments provided inter alia for payments to children of fully insured individuals to continue to age 22 where the child is a full-time student, indicates that the intent of Congress was to provide a substitute for the support lost upon the death of the parent. This additional financial assistance was considered important in light of the increasing need for a college degree in order to compete effectively in the job market. The Senate report explains—

> Under present law a child beneficiary is considered dependent, and is paid benefits, until he reaches age 18, or after that age if he was disabled before age 18 and is still disabled. The committee believes that a child over age 18 who is attending school full-time is dependent just as a child under 18 or a disabled older child is dependent, and that it is not realistic to stop such a

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[2] Base years refer to the 4 years immediately preceding the year in which income averaging is elected.

[3] Sec. 1303(c) provides:

> (1) IN GENERAL.—For purposes of this part, an individual shall not be an eligible individual for the computation year if, for any base period year, such individual (and his spouse) furnished less than one-half of his support.

[4] Petitioner does argue, however, that the exception provided in sec. 1303(c)(2)(A) is unconstitutional. We will address that argument later in our opinion.

child's benefit at age 18. A child who cannot look to a father for support (because the father has died, is disabled, or is retired) is at a disadvantage in completing his education as compared with the child who can look to his father for support. Not only may the child be prevented from going to college by loss of parental support and loss of his benefits; he may even be prevented from finishing high school or going to a vocational school. With many employers requiring more than a high school education as a condition for employment, education beyond the high school level has become almost a necessity in preparing for work.

The committee believes it is now appropriate and desirable to provide social security benefits for children between the ages of 18 and 22 who are full-time students and who have suffered a loss of parental support. * * * The median age of students graduating from high school is about 18; providing benefits up to age 22 would mean that for many children benefits could continue for the time it takes to complete a 4-year college course.

[S. Rept. 404, to accompany H.R. 6675 (Pub. L. 89-97), 89th Cong., 1st Sess. 96-97 (1965).]

Neither the Internal Revenue Code provisions that pertain to income averaging nor the regulations thereunder provide any specific guidance with respect to whether social security benefits are to be considered as support provided by the grantor (the Federal Government) or as support provided by the recipient (such as petitioner herein). The parties agree, and our research confirms, that there is no case directly on point.

Petitioner argues that, because the term "support" is not defined in section 1303, nor in the regulations thereunder, the Court should look to section 152 (which pertains to dependency exemptions) because that section does expressly define "support." Petitioner notes that even though the regulations accompanying the income averaging provisions no longer expressly reference the regulations accompanying section 152 as to the meaning of "support" (T.D. 7196, 1972-2 C.B. 499), the similarity of the statutory language in sections 1303 and 152 justify our reliance on decisions involving section 152.

Petitioner argues that the regulations under section 152 expressly define support, and points in particular to sec. 1.152-1(a)(2)(ii), Income Tax Regs., which provides in relevant part:

In computing the amount which is contributed for the support of an individual, there must be included an amount which is contributed by such individual *for his own support*, including income which is ordinarily

excludable from gross income, *such as benefits received from the Social Security Act.* [Emphasis added by petitioner.]

Petitioner also relies on a number of Memorandum Opinions of this Court that address dependency exemptions under section 152. *Brooks v. Commissioner*, T.C. Memo. 1957–76 is cited for the proposition that social security death benefits paid to a child constitute support provided by the child. *Sumner v. Commissioner*, a Memorandum Opinion of this Court dated February 15, 1954, is cited for the proposition that Veterans' Administration death benefits constitute support provided by the recipient. In addition, Rev. Rul. 74–543, 1974–2 C.B. 39, and Rev. Rul. 57–344, 1957–2 C.B. 112, are cited as support for petitioner's position.

Having reviewed the authorities cited by petitioner, we do not believe that they are persuasive. Those cases (and the other authorities cited by petitioner) concern a parent or other taxpayer who claims a dependency exemption on the basis that he provides more than one-half of the would-be dependent's support. In making that determination under section 152, the total amount of support provided by the individual claiming the support exemption during the year is compared with the total amount of support provided by all other sources (including support which the individual "dependent" provided to himself) in order to determine if the taxpayer provided more than one-half of all the support. See sec. 1.152–1(a)(2)(i), Income Tax Regs. Those cases did not decide, nor did they even need to address, *who* (other than the taxpayer) provided a particular kind of support as between the third-party grantors (such as the Social Security Administration) and the grantee (namely, the claimed dependent person). Such an issue simply would not be relevant under section 152, once it was determined that the support in question was provided by a source other than the taxpayer claiming the dependency exemption.

Contrary to petitioner's argument, sec. 1.152–1(a)(2)(ii), Income Tax Regs., has not been interpreted, even within the context of the dependency exemption, to require that all benefits paid under the Social Security Act are to be considered as support provided by the recipient. In *Lutter v. Commissioner*, 61 T.C. 685 (1974), affd. per curiam 514 F. 2d 1095 (7th Cir. 1975), payments were made to a parent under the Federal-State Aid to Families With Dependent Children

(AFDC) program. We rejected the taxpayer's argument therein that because the legislative intent of Congress was to give the money to the parents of dependent children to spend as the parents saw fit, the payments should be considered as support provided by the parents to the children. In so ruling, we pointed out that the payments were "earmarked for the children" (61 T.C. at 689) and that the parents were accountable to the State to ensure that the payments were used in the best interests of the child. We held that "the AFDC benefits were received by petitioner for the benefit of her minor children and constitute 'support' by the State of Illinois, not 'support' furnished by petitioner." 61 T.C. at 690.

With regard to the intended scope of the income averaging provision, committees of both the Senate and the House of Representatives emphasized two major concerns, as follows:

> To be eligible for averaging, one of the principal concerns is that the individual's income must have been subject to tax by the United States throughout the entire base period as well as the computation year. * * *
>
> A second concern of this provision is that the individual be a member of the labor force in both the computation year and the 4 base period years. It has been necessary, however, to approximate this result in some cases. The general rule provides that the individual and his spouse must have furnished one-half or more of his own support in each of the base period years. However, it was not intended to exclude from the benefits of the averaging provision an individual who, although in the labor force, was unemployed in part or all of the base years. For that reason, individuals generally are eligible for averaging if they are 25 years old and there have been at least 4 years since the individual attained age 21 when he was not a full-time student. Thus, generally, individuals age 25 or over will be eligible for averaging so long as they have been out of school for at least 4 years since age 21.
>
> [H. Rept. 749, 88th Cong., 1st Sess. (1963), 1964–1 C.B. (Part 2) 125, 238; S. Rept. 830, 88th Cong., 2d Sess. (1964), 1964–1 C.B. (Part 2) 505, 648.]

Heidel v. Commissioner, 56 T.C. 95 (1971), concerned whether a grant-in-aid athletic scholarship constituted support furnished by the recipient within the meaning of section 1303(c)(1). We noted therein that section 1303 is a relief section that should be given "close scrutiny" and that it is not entitled to a liberal interpretation. (56 T.C. at 103, citing *Hendricks v. Commissioner*, 406 F.2d 269 (1969), affg. per curiam a Memorandum Opinion of this Court.) After reviewing the above committee reports, we concluded that the taxpayer therein:

hardly qualified, "within the letter and spirit of the Congressional grant," as indicated by the committee reports, as an individual to whom relief was sought to be granted by the income-averaging provisions. Throughout the base period years he was a full-time student, was not a regular member of the labor force, and the value of the scholarship which he claims as support furnished to himself was not subject to U.S. taxes. [56 T.C. at 103.]

See also *Jolitz v. Commissioner*, 73 T.C. 732 (1980).

Similar observations could be made regarding petitioner in the present case, who also was a full-time student throughout the 4 base-period years and was not a "regular" member of the labor force. He also was not taxed on the benefits at issue herein, and did not pay any Federal income taxes for 3 of the 4 base period years.

In *Sharvy v. Commissioner*, 67 T.C. 630 (1977), affd. per curiam 566 F.2d 1118 (9th Cir. 1977), the Court considered whether amounts received from a National Defense Education Act (NDEA) fellowship and a teaching assistantship qualified as support which the recipient provided to himself within the meaning of section 1303(c)(1). The taxpayer argued that when a "no-string"[5] tax-exempt fellowship (or other similar "support") is provided by a grantor to an individual, those funds become the property of the grantee, who is thereafter free to do with them as he wishes, and that when these funds subsequently are expended for the recipient's support, they constitute support furnished by the recipient for purposes of income averaging.

We rejected that argument and stated that—

> Were we to accept such a contention, we would make nugatory the support rule limitations; i.e., anyone could become eligible for income averaging merely by claiming he "supported" himself by using "unrestricted" gifts from family, friends, or institutions. [67 T.C. at 640.]

Having reviewed the legislative history, the cases and other relevant authority, we conclude that petitioner is not an "eligible individual" for purposes of income averaging. The facts of this case (namely, that petitioner was a full-time student throughout the 4 base-period years, was not a full-time member of the labor force, and the fact that the funds that he seeks to characterize as "support" were not subject to Federal

---

[5] An example of support with "strings," under *Sharvy*, would be the AFDC program, where the recipient-parent is under an obligation to expend the funds for the benefit of the child.

income taxation) are virtually indistinguishable from those in *Heidel v. Commissioner, supra*.

As in *Sharvy*, petitioner herein performed no services to earn the funds received. The payments herein were received by petitioner solely because of the death of his father, who was a "fully insured" person (under the social security system) at the time of his death, while petitioner was a full-time student under the age of 22. The benefits received were calculated by reference to his father's earnings and were, in effect, statutory substitutes for the support his father presumably would have provided had he lived. Clearly, had petitioner's father lived and made the payments in issue herein, such payments would constitute amounts contributed by the father, not by petitioner.

We hold that the payments petitioner received from the Social Security Administration were "support" provided by an independent source (namely, the Federal Government), and not by petitioner. We therefore need not reach the issue of whether the Veterans' Administration payments qualify as support furnished by petitioner.

Next, we consider petitioner's argument that, even if he is found to have provided less than 50 percent of his own support, he is entitled to income average because the exception to section 1303 contained in section 1303(c)(2)(A) is unconstitutional as written, and therefore should be enlarged to include petitioner's situation. That section provides that an individual will be eligible for income averaging, among other things, if the individual attained age 25 prior to the close of the computation year, and was not a full-time student during the 4 taxable years commencing upon attaining the age of 21 and ending with the computation year.[6] Petitioner argues that this exception creates an arbitrary classification without a rational basis because it unconstitutionally favors unemployed persons over college students. Petitioner also argues that, under the statute, a taxpayer could do anything other than attend school between the ages of 21 and 25, attend college for the next 4

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[6] Sec. 1303(c)(2)(A) provides:

(2) EXCEPTIONS.—Paragraph (1) shall not apply to any computation year if—

(A) such year ends after the individual attained age 25 and, during at least 4 of his taxable years beginning after he attained age 21 and ending with his computation year, he was not a full-time student.

years, graduate at age 29, and immediately begin to income average upon obtaining employment. Petitioner argues that his situation is virtually identical to the foregoing scenario, but that petitioner is denied the benefits of the statute solely because of his age. The only case cited by petitioner in support of his argument that the exception is unconstitutional is *Kahn v. Shevin*, 416 U.S. 351 (1974), which petitioner cites for the proposition that the Fifth Amendment due process clause and the 14th Amendment equal protection clause are applicable to tax laws. While we agree with petitioner that constitutional protections apply to tax laws, we disagree with petitioner's assertions that the provisions in section 1303(c)(2)(A) create an arbitrary classification and/or constitute unconstitutional age discrimination.

Generally, statutory classifications are valid provided they bear a rational relation to a legitimate governmental purpose. *Regan v. Taxation With Representation of Washington*, 457 U.S. 1129 (1982). Statutes are subjected to a higher level of scrutiny if they interfere with the exercise of a fundamental right, such as freedom of speech, or employ a suspect classification, such as race. See, e.g., *Harris v. McRae*, 448 U.S. 297, 322 (1980). Legislatures have particularly broad latitude in creating classifications and distinctions in tax statutes. 457 U.S. at 1132.

It is apparent from the legislative history that the general purpose of the income averaging provisions was to provide relief from the effects of the progressive tax rate system to members of the work-force whose incomes fluctuate significantly from year to year. See H. Rept. 749, 88th Cong., 1st Sess. (1963), 1964–1 C.B. (Part 2) 125, 234; S. Rept. 830, 88th Cong., 2d Sess. (1964), 1964–1 C.B. (Part 2) 505, 644. The classification to which petitioner objects represents an effort on the part of Congress to attain the legitimate governmental purpose of limiting the availability of income averaging to those individuals who comprise the work force. The exception that draws petitioner's attack (namely, section 1303(c)(2)(A)) represents an effort by Congress to provide income averaging relief to those persons who, in fact, have been unemployed. Thus, the purpose of the statutory classification is to provide a practical test to differentiate between those who comprise the labor

force and those who do not, not an attempt to discriminate against college students or young people.

There are a number of sections in the Internal Revenue Code that provide for differing tax treatment depending upon the taxpayer's age. For example, an additional $1,000 exemption is provided to a taxpayer who attains the age of 65 before the end of his taxable year. Sec. 151(c). Also, if a taxpayer has attained the age of 55 before the date of sale of his principal residence, and if during the 5-year period ending on the date of such sale the property has been owned and used by the taxpayer as his principal residence for periods aggregating 3 years or more, the taxpayer may exclude up to $100,000 of such gain from gross income. Sec. 121(a) and (b).[7] See also *United States v. Maryland Savings-Share Insurance Corp.*, 400 U.S. 4 (1970). We therefore reject petitioner's constitutional challenge to section 1303(c)(2)(A).

We next consider the applicability of the additions to tax pursuant to section 6651(a), for failure to file a timely 1979 Federal income tax return, and section 6653(a), for negligence or intentional disregard of rules and regulations. Petitioner claims to have timely filed a so-called "Fifth Amendment" return. Respondent has no record of receiving such a "return." Although the document is not admitted into evidence, it is obvious from the copy of the document that petitioner alleges to have filed (which petitioner attached to his opening brief) that, even if it had been filed, it would not constitute a valid Federal income tax return because it contained no information relating to the taxpayer's income and deductions. *Hatfield v. Commissioner*, 68 T.C. 895, 898 (1977). See also *Beard v. Commissioner*, 82 T.C. 766 (1984).

Petitioner bears the burden of proving that his failure to file a timely return was due to reasonable cause and not willful neglect. *Neubecker v. Commissioner*, 65 T.C. 577, 586 (1975). Petitioner testified that he was following the recommendations of a local "tax protester" group in filing a "Fifth Amendment return," that he did so without verifying the accuracy of their statements by checking any relevant legal authorities, and that he now regrets his actions. Petitioner had previously filed Federal income tax returns with respect to the

[7] See *Woolf v. Commissioner*, T.C. Memo. 1981-286, for a discussion of the constitutionality of sec. 121.

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years 1976, 1977, and 1978, and was well aware of the legal requirements to do so. Under the circumstances, we find that petitioner is liable for the section 6651(a) addition to tax. Because petitioner has failed to prove that his failure to timely file his 1979 Federal income tax return was not due to either negligence or intentional disregard of rules and regulations, we also find that he is liable for the section 6653(a) addition to tax. *Foster v. Commissioner*, 80 T.C. 34, 237 (1983); *Bixby v. Commissioner*, 58 T.C. 757, 791–792 (1972).

The final issue is the applicability of the addition to tax under section 6654 for underpayment of estimated tax by an individual. Petitioner also bears the burden of proof on this issue (*Hollman v. Commissioner*, 38 T.C. 251, 263 (1962)). Petitioner evidently did not have any Federal income taxes withheld from the wages he earned at Schlumberger Technology Corp., nor did he make any estimated tax payments with respect to those wages.

The addition to tax under section 6654(a) is mandatory unless petitioner can demonstrate that he comes within one of the computational exceptions of section 6654(d) (*Grosshandler v. Commissioner*, 75 T.C. 1, 20–21 (1980)), which petitioner has failed to do. Extenuating circumstances are irrelevant. *Estate of Ruben v. Commissioner*, 33 T.C. 1071, 1072 (1960). We therefore uphold respondent on this issue.

Respondent, however, acknowledges that in computing the amount of the section 6654 addition to tax for purposes of the statutory notice of deficiency, he did not take into account $857.66 withheld from petitioner's wages at the Salt River Project. Respondent is to take that amount into consideration in making the Rule 155 computations herein.

Decision will be entered under Rule 155.

MARY K. S. OGDEN, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 22866–82. Filed May 16, 1985.

L, a Louisiana partnership in commendam (equivalent to a limited partnership) was formed in 1977 to make secured loans

on, acquire, own, sell, and manage real estate. New partners in commendam (equivalent to limited partners) were admitted to L in July, November, and December 1978. P became a partner in commendam in November, acquiring a 2-percent interest in the partnership. Under its partnership agreement, L's 1978 year was divided into four periods of unequal length, with each period beginning and ending on the admission of new partners. To account for the partners' varying interests in the partnership, L's overall tax loss for 1978 was allocated pro rata to the periods based on the number of days in each period. In accordance with the terms of the partnership agreement, P received a special allocation of approximately 23 percent of the third period's pro rata share of L's overall loss, and no allocation of L's losses for the first, second, or fourth periods. P's capital account was to be reduced for losses allocated to her; but upon partnership liquidation or sale of partnership assets, proceeds would not be distributed in accordance with capital account balances, and P would not be required to restore any deficit in her capital account. *Held*:

1. The special allocation to P lacked substantial economic effect. Sec. 704(b), I.R.C. 1954.

2. For purposes of redetermining P's distributive share of L's net loss, her "interest in the partnership" within the meaning of sec. 704(b) must reflect the variation of her ownership interest during the year. Sec. 706(c)(2)(B), I.R.C. 1954.

D. Irvin Couvillion, for the petitioner.
A. Albert Ajubita, for the respondent.

OPINION

SIMPSON, *Judge*: The Commissioner determined a deficiency of $26,814.54 in the petitioner's Federal income tax for 1978. The issues for decision are: (1) Whether a special allocation to the petitioner under a partnership agreement had substantial economic effect within the meaning of section 704(b)(2) of the Internal Revenue Code of 1954[1]; and (2) if such special allocation lacked substantial economic effect, what was the petitioner's interest in the partnership, within the meaning of section 704(b), for purposes of redetermining her distributive share of loss from the partnership.

All of the facts have been stipulated, and those facts are so found.

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[1] All statutory references are to the Internal Revenue Code of 1954 as in effect during the year in issue.

The petitioner, Mary K.S. Ogden, resided in Lafayette, Louisiana, at the time she filed her petition in this case. She filed her Federal income tax return for 1978 with the Internal Revenue Service Center, Austin, Texas.

The petitioner was admitted to the Riverside Investment Jackson Partnership (Riverside)[2] on November 14, 1978. Riverside was originally organized in January 1977 as a joint venture of four individuals, Robert G. Jackson, Charles B. Harvey, Sr., John C. Yemelos, and Huey J. Wilson. The venture was formed to make secured loans on a real estate development in Baton Rouge, Louisiana, known as Corporate Square, and to own and operate various other real properties. In January 1977, Riverside lent a total of $2 million to four partnerships involved in the Corporate Square development (the Corporate Square partnerships). Riverside obtained the funds loaned to the Corporate Square partnerships by borrowing $2 million from American Bank & Trust Company of Baton Rouge (American Bank). The loan from American Bank to Riverside was guaranteed by the four members of the joint venture; the men agreed among themselves that each would guarantee the following portions of the debt:

Robert G. Jackson	$600,000
Charles B. Harvey, Sr	400,000
John C. Yemelos	600,000
Huey J. Wilson	400,000

During 1977, Mr. Wilson withdrew from Riverside, and the guarantees for the $2-million debt were restructured in order to hold Mr. Wilson harmless from liability. Rolfe H. McCollister and Mr. Jackson agreed to assume liability for that portion of the debt guaranteed by Mr. Wilson. However, Mr. McCollister did not become a member of Riverside until July 14, 1978.

On December 30, 1977, Riverside was converted from a joint venture to a partnership in commendam under Louisiana law, which is equivalent to a limited partnership for Federal tax purposes. In return for capital contributions consisting of their continuing guarantees of the debt owed to American Bank, Mr. Jackson became the partnership's general partner and Mr. Harvey and Mr. Yemelos became Class A partners in

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[2]The name of the partnership was changed on several occasions in 1977 and 1978. For convenience, we shall refer to it as "Riverside" throughout this opinion.

commendam, which are equivalent to limited partners. Four new partners were also admitted into the partnership as Class B partners in commendam. The partners executed a written partnership agreement, which stated that the partners' respective capital contributions and interests in partnership stock[3] were as follows on December 30, 1977:

	Contribution to partnership stock	*Interest in partnership stock*	
General partners:			
Robert G. Jackson	continuing guaranty on $1 million of partnership debt	45.875%	
Total			45.875%
Class A partners:			
Charles B. Harvey, Sr.	continuing guaranty on $400,000 of partnership debt	18.350%	
John C. Yemelos	continuing guaranty on $600,000 of partnership debt	27.525%	
Total			45.875%
Class B partners:			
Roland M. Toups	$56,000	2.06%	
H. Alva Brumfield III	50,000	1.84%	
Murry A. Decoteau	68,400	2.51%	
Laurence de la Bretonne	50,000	1.84%	
Total	224,400		8.25%
Grand total			100.00%

Riverside's loan to the Corporate Square partnerships became uncollectible in 1978, when three of the partnerships instituted bankruptcy proceedings and were discharged of all debts by order of the Bankruptcy Court, dated May 25, 1978. The Bankruptcy Court determined that a secured indebtedness due and owing to Chemical Bank of New York exceeded the value of the debtors' properties, leaving no equity or value

[3]Under the partnership agreement executed by the partners, the partners received a percentage ownership interest in "partnership stock" in return for their capital contributions; "partnership stock" was defined as the "cash or other property contributed or furnished to the Partnership by a Partner as set out in Article 2808 of the Revised Civil Code of Louisiana and other applicable law, as amended." The parties have stipulated that an ownership interest in partnership stock was equivalent to a "capital interest" in the partnership.

in and to such properties for any other secured or unsecured creditor. Under the distribution schedule filed with that court on July 18, 1978, Riverside's claim of $2,297,926.60 was relegated to that of general, unsecured creditor.

Sometime between May 15 and June 1, 1978, Riverside proposed to buy from Chemical Bank and its affiliates the three pieces of real property owned by the bankrupt partnerships. In order to finance the acquisition of the properties, Riverside admitted 23 new Class C partners in commendam on July 14, 1978; but when the partnership was unable to obtain bank financing for the purchase of the bankrupts' properties, the purchase agreement with Chemical Bank fell through, and the partnership was forced to return to nine of the new partners their entire capital contributions, plus interest, and the expenses incurred by each partner in connection with his investment. Fourteen of the newly admitted partners chose to remain in the partnership as Class C partners in commendam, and Mr. McCollister was admitted to the partnership as a Class A partner in commendam. The record does not clearly indicate what the partners' partnership stock interests were during the period of July 14 to November 13, 1978.

Sometime after July 14, 1978, Riverside made plans to purchase two other unrelated properties in Baton Rouge: an office building known as the I-12 Office Center and an apartment complex named Batture Apartments. To effect the purchase of these properties, the partnership admitted five additional Class C partners in commendam on November 14, 1978. The petitioner was one of the partners admitted at such time. She contributed $35,600 in cash and a note in return for a 2-percent interest in partnership stock. At this time, Mr. McCollister's interest in the partnership was converted from that of a Class A partner in commendam to that of a general partner. According to Riverside's partnership agreement, as amended on November 14, 1978, to reflect the admission of the new partners, the partners had made capital contributions to, and possessed stock ownership interests in, the partnership as follows:

	Contribution to partnership stock	*Interest in partnership stock*
General partners:		
(Jackson, McCollister)	$2,430,750	30.00%

	Contribution to partnership stock	*Interest in partnership stock*
Class A partners: (Harvey, Yemelos)	$60,000	2.00%
Class B partners: (Toups, Brumfield, Decoteau, de la Bretonne)	274,400	18.00%
Class C partners: (18 partners, including Mary K.S. Ogden and 4 other newly admitted partners)	797,150	44.75%
Class C units[4] unsubscribed:	- - -	5.25%
Total		100.00%

On November 14, 1978, Riverside acquired the Batture Apartments and the I-12 Office Center.

The Class C units which went unsubscribed in November were acquired on December 15, 1978, by William Champ Emerson, an existing Class C partner in commendam, who increased his interest in partnership stock from 18.50 percent to 22.50 percent, and by Terence McCoy, who was admitted as a new Class C partner in commendam with a 1.25-percent interest in the partnership. After the subscription of those Class C units, the capital contributions of the Class C partners in commendam totaled $890,000, and their ownership interests in partnership stock totaled 50 percent; the stock ownership interests of the general, Class A, and Class B partners remained as they were on November 14, 1978.

On December 13, 1978, the $2-million debt owed by Riverside to American Bank was extinguished as a result of payments previously made by the following persons in the designated amounts:

Date of payment	*Payor*	*Amount*
8/22/78	Huey J. Wilson	$400,000
9/15/78	John C. Yemelos	480,000
9/15/78	(unknown)	120,000
9/19/78	Robert G. Jackson	573,000

[4]Under the Riverside partnership agreement, a "unit" was defined as a 0.5-percent ownership right of a partner in commendam in and to partnership stock.

Date of payment	*Payor*	*Amount*
9/20/78	Rolfe H. McCollister	$27,000
12/13/78	Charles B. Harvey, Sr.	400,000
	Total	2,000,000

With the exception of the payments from the unknown source and from Mr. McCollister, all of the payments to American Bank were funded by personal loans incurred by the listed payors.

On its partnership return of income for 1978, Riverside reported a net loss of $2,600,492.54, which included a bad debt deduction of $2,140,791.37 for the debt owed to Riverside by the Corporate Square partnerships. Upon audit of the partnership return by the Internal Revenue Service, the net loss was reduced to $2,577,536 as a result of the disallowance of $22,956 of expense deductions. Riverside and the petitioner agree with the adjustment to the partnership loss.

Because Riverside experienced variations in partnership interests in 1978 due to the admissions of new partners on July 14, November 14, and December 15, the partnership divided the year into four periods of unequal length and prorated its total loss for the year to such periods on the basis of the number of days in each period. The Commissioner does not object to Riverside's method of accounting for the partners' varying interests, but he has recomputed the allocation using the redetermined partnership loss of $2,577,536. The four periods and the amount of loss allocated to each period by the Commissioner are as follows:

Period	*Pro rata allocation as redetermined*[5]
First period— 1/1/78–7/13/78..... (194 days)	$1,369,977.73
Second period— 7/14/78–11/13/78..... (123 days)	868,595.00

[5]The parties stipulated to figures which differed by a few cents from the figures appearing in this column and which also did not add up to the total, $2,577,536. We have corrected such figures based on the contents of stipulated exhibits and by "rounding" certain figures.

Period	*Pro rata allocation as redetermined*
Third period—	
11/14/78–12/13/78	$211,852.27
(30 days)	
Fourth period—	
12/14/78–12/31/78	127,111.00
(18 days)	2,577,536.00

The petitioner agrees with the prorated allocation as redetermined by the Commissioner.

Riverside's partnership agreement was amended again on December 15, 1978, upon the subscription of the last Class C units, to provide in article 8.02 thereof that partnership items of income, gain, loss, deduction, and credit were to be allocated among the partners in accordance with the following scheme for the designated years:

	1978				
	First period	*Second period*	*Third period*	*Fourth period*	*1979–83*
General partners					
Robert G. Jackson	87.26%	0	0	0	0.25%
Rolfe H. McCollister	0	0	0	0	0.25%
Total	87.26%	0	0	0	0.50%
Class A partners					
Charles B. Harvey, Sr.	4.29%	0	0	0	0.25%
John C. Yemelos	0.60%	0	0	0	0.25%
Total	4.89%	0	0	0	0.50%
Class B partners					
Roland M. Toups	5.71%	0	0	0	7.49%
H. Alva Brumfield	0	0	0	0	6.68%
Murry A. Decoteau	0	0	0	0	9.15%
Laurence de la Bretonne	2.14%	0	0	0	6.68%
Total	7.85%	0	0	0	30.00%

	First period	*Second period*	*Third period*	*Fourth period*	*1979–83*
Class C partners					*69.00%
Partners admitted 7/14/78	0	100.00%	57.25%	0	
Partners admitted 11/14/78	0	0	42.75%	0	
Partners admitted 12/15/78:					
William Champ Emerson	0	0	0	76.19%	
Terence McCoy	0	0	0	23.81%	
Total	0	100.00%	100.00%	100.00%	69.00%
Grand total	100.00%	100.00%	100.00%	100.00%	100.00%

Article 8.01 of the partnership agreement provided that for years after 1983, partnership items were to be allocated "to the Partners in Commendam and their assignees, and the General Partner in proportion to their ownership of Partnership Stock, unless otherwise agreed among the Partners." The partners' capital accounts were to be adjusted to reflect any allocation to them of items of income, gain, loss, or deduction. However, in the event of a liquidation or termination of the partnership, partners having deficit balances in their capital accounts would not be required to make up the deficits in these accounts to the partnership or its creditors, nor would such partners be required to receive a proportionately smaller share of partnership assets. Upon the sale of partnership property at a profit, income, to the extent "recaptured" under section 1245 or 1250, would be allocated (or "charged back") to those partners to whom the depreciation deductions had been allocated previously, but, as will be explained below, the cash proceeds of the sale would be distributed without regard to tax allocations or capital account balances. The partners' capital accounts were of importance only for accounting and tax purposes.

Under article 8.06 of the partnership agreement, positive cash flow was to be accumulated in 1978, and then distributed in years 1979 through 1983 according to a schedule which gave a "priority distribution right" to a specified amount of such cash flow to the Class B and C partners in commendam; the

*For the years 1979 through 1983, 69 percent of the partnership's items of income, gain, loss, deduction, or credit were to be allocated among the Class C partners, presumably in proportion to each partner's ownership of partnership stock.

cash would be distributed among the Class B and C partners in proportion to their ownership of partnership stock. For years 1984 and after, Class B and C partners in commendam were to have a "priority distribution right" to any positive cash flow in the amount of $0.08 for every $1 of their "net capital contributions" (cash contributions less (1) priority cash flow received, (2) proceeds from refinancing, and (3) proceeds from sale of partnership property); any additional positive cash flow might, in the discretion of the general partners, be distributed to all partners in the same proportions as their ownership of partnership stock. In 1980, Riverside distributed positive cash flow arising from its operations in 1979 and 1980 to the Class B and C partners in commendam in accordance with their "priority distribution rights" under the partnership agreement. In 1980, 1982, and 1983, Riverside distributed cash proceeds made available by the refinancing of partnership debts to all partners on the basis of their ownership interests in partnership stock.[7]

Under article 8.04 of the partnership agreement, the proceeds of a sale of all or part of the partnership's property were to be distributed in the following order of priority: (1) To creditors; (2) to the general partner in repayment of loans to the partnership; (3) to the Class B and C partners in commendam in payment of any unsatisfied cumulative "priority distribution rights" to positive cash flow; (4) to the Class B and C partners in the amount of their "net capital contributions"; and (5) to all partners in the same percentages as their ownership of partnership stock.

Riverside allocated its reported 1978 net loss (as prorated over the four periods described above) to its partners in accordance with article 8.02 of the partnership agreement. The petitioner's distributive share of the loss consisted of 22.8 percent, or $48,732.52, of the third period's pro rata allocation of the partnership loss; she reported no distributive share of the partnership's loss allocated to the first, second, or fourth periods. On her Federal income tax return for 1978, the

[7] The parties have stipulated that the distributions of refinancing proceeds were "based upon the capital interests of the partners" and were "based upon the ownership of partnership stock." This appears to be true for 1980, but in 1982 and 1983, the general partners and the Class A partners in commendam received no such distributions according to a stipulated exhibit. We have relied on the parties' stipulation, as the fact is not crucial to the case.

petitioner claimed a loss of $48,733 arising from her membership in Riverside.

In the notice of deficiency, the Commissioner reduced the petitioner's distributive share of Riverside's net loss to $7,276.44. He determined that the special allocation to the petitioner of 22.8 percent of the third period's pro rata share of the partnership loss lacked economic substance, and that, consequently, her proper distributive share should be based on her percentage interest in partnership stock during the third period and the fourth period.[8]

Partners must report their distributive shares of partnership income, gain, loss, deduction, or credit. Sec. 702(a). Section 704(a) provides that a "partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement." Thus, partners have "great latitude in determining themselves by their partnership agreement what their distributive shares will be." *Goldfine v. Commissioner*, 80 T.C. 843, 849–850 (1983). However, the partners' ability to make special allocations of partnership items is not unlimited: section 704(b)(2) states that if "the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect," it will be disregarded, and the partner's distributive share "shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances)." In addition, section 706(c)(2)(B), as in effect during the year in issue, provides that where a partner's

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[8]The petitioner's distributive share of the partnership's 1978 net loss was redetermined by the Commissioner as follows:

THIRD PERIOD DISTRIBUTIVE SHARE

(1) Petitioner's percentage of outstanding Class C partnership stock: 4.46927% (computed by dividing petitioner's 2.00% interest by the total 44.75% interest owned by Class C partners)

(2) Petitioner's interest in partnership stock during third period: 2.23463% (computed by multiplying 4.46927% by 50.00%, the total ownership interest of Class C partners)

(3) Petitioner's distributive share of loss for third period: $4,734.20 (computed by multiplying 2.23463% by $211,852.27, the third period's pro rata share of the year's net loss)

FOURTH PERIOD DISTRIBUTIVE SHARE

(1) Petitioner's interest in partnership stock during fourth period: 2.00%

(2) Petitioner's distributive share of loss for fourth period: $2,542.24 (computed by multiplying 2.00% by $127,112.00, the fourth period's pro rata share of the year's net loss)

interest in the partnership varies during the year, such partner's distributive share "shall be determined by taking into account his varying interests in the partnership during the taxable year." The Commissioner has conceded that Riverside's method of accounting for its partners' varying interests in 1978—the allocation of its yearend net loss ratably over the year—is acceptable under section 706(c)(2)(B) and does not result in a prohibited retroactive allocation of partnership losses to the petitioner. See, e.g., *Johnsen v. Commissioner*, 84 T.C. 344 (1985), supplemental opinion to 83 T.C. 103 (1984). Therefore, the primary issue for decision is whether the partnership agreement's special allocation to the petitioner of 22.8 percent of the net loss allocated to the third period lacks "substantial economic effect" within the meaning of section 704(b)(2).

We observe, at the outset, that commentators have suggested that a plan of special allocations, such as that adopted in Riverside's partnership agreement, may be an effective way of achieving the same result as a retroactive allocation of losses to newly admitted partners, but without violating the prohibition of section 706(c)(2)(B):

> Another possible method of mitigating the prohibition in §706(c)(2)(B) against retroactive allocations would be to use a special allocation either of deductions or of bottom line losses.
>
> For example, assume that AB partnership, using either the cash or accrual method of accounting, realizes income of $30,000 per month and pays expenses of $50,000 per month during 1981. Its loss for the year is $240,000. C becomes a one-third partner on December 1, 1981, by contributing cash to the partnership. The partners want to give C the benefit of one-third of the loss for the entire year, a deduction of $80,000. Under §706(c)(2)(B), it is not permissible to allocate to C any portion of the loss prior to December 1, 1981, and an interim closing of the books will not help. Using a proration based upon the time C was in the partnership, C's share of the loss would be ⅓ of ½ of $240,000, or $6,667.
>
> If the entire loss for December were specially allocated to C, C's share of the loss would increase from $6,667 to $20,000. Although this is still not the $80,000 C wanted, it is a substantial improvement. The remaining $60,000 of deduction might be given to C by a special allocation to C of the first $60,000 of partnership losses for 1982.
>
> *These special allocations should be permitted provided they meet the substantial economic effect test of §704(b)(2).* Although the effect of this allocation is to undercut the retroactive allocation prohibition, there is no reason why it should not be given the same effect as any other special allocation in the absence of sham.

[2 A. Willis, J. Pennel & P. Postlewaite, Partnership Taxation, sec. 87.05, at 87-14 to 87-15 (3d ed. 1981); fn. ref. omitted; emphasis added.]

See also M. Cowan, "Retroactive partnership allocations: New restrictions do not bar the technique," 46 J. Tax. 332, 335 (1977). As the petitioner herself points out, the allocation to her of 22.8 percent of the third period's pro rata share of the year's loss was equal to 1.87 percent of the total year's loss, or only slightly less than a retroactive allocation of the total year's loss based on her 2-percent capital interest. The Commissioner does not dispute that a special allocation may be used to achieve the same result as a retroactive allocation of the loss, but he points out that any such special allocation must have "substantial economic effect" and argues that the allocation in this case did not have substantial economic effect.

Before 1976, section 704(b)(2) provided that a special allocation under a partnership agreement would not be recognized if its principal purpose was to avoid or evade any income tax. Section 1.704-1(b)(2), Income Tax Regs., was promulgated under the prior law and provided several tests to determine tax evasion or avoidance.[9] The regulation's "substantial economic effect" test became the preeminent test of tax evasion or avoidance (*Harris v. Commissioner*, 61 T.C. 770 (1974); *Orrisch v. Commissioner*, 55 T.C. 395 (1970), affd. per curiam in an unreported opinion (9th Cir., Mar. 3, 1973, 31 AFTR 2d 73-1069)), and in the Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1520, 1548, the "substantial economic effect" test was elevated from the regulation to the statute. The remaining tests in the regulation are now of little, if any, importance (*Goldfine v. Commissioner*, 80 T.C. at 851[10]), being characterized as "Other factors that could possibly relate to the

[9] Sec. 1.704-1(b)(2), Income Tax Regs., provides in pertinent part:

"In determining whether the principal purpose of any provision in the partnership agreement for a special allocation is the avoidance or evasion of Federal income tax, the provision must be considered in relation to all the surrounding facts and circumstances. Among the relevant circumstances are the following: Whether the partnership or a partner individually has a business purpose for the allocation; whether the allocation has 'substantial economic effect', that is, whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences; whether related items of income, gain, loss, deduction, or credit from the same source are subject to the same allocation; whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated item could reasonably be estimated; the duration of the allocation; and the overall tax consequences of the allocation." • • •

[10] *Miller v. Commissioner*, T. C. Memo. 1984-336.

determination of the validity of an allocation." S. Rept. 94–938 (1976), 1976–3 C.B. (Vol. 3) 49, 138.[11] However, the 1976 revision of section 704(b)(2) was less substantive than it may appear; even under the prior law it was stated that "An allocation that lacks 'substantial economic effect' will not be saved by meeting the other five factors in the regulation." *Hamilton v. United States*, 231 Ct. Cl. 517, 527, 687 F.2d 408, 414 (1982); see also *Allison v. United States*, 701 F.2d 933, 937 (Fed. Cir. 1983); *Boynton v. Commissioner*, 649 F.2d 1168, 1173 (5th Cir. 1981), affg. 72 T.C. 1147 (1979); 1 W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners, par. 10.02, at 10–10 to 10–11 (1977).

The petitioner bears the burden of proving that the allocation to her under the partnership agreement has " 'substantial economic effect,' i.e., whether the allocation may actually affect the dollar amount of * * * [her share] of the total partnership income or loss independently of tax consequences." S. Rept. 94–938, *supra*, 1976–3 C.B. (Vol. 3) at 138; sec. 1.704–1(b)(2), Income Tax Regs.; Rule 142(a), Tax Court Rules of Practice and Procedure. The test for substantial economic effect has been called a "capital account analysis" (1 W. McKee, W. Nelson & R. Whitmire, *supra* at par. 10.02[2], p. 10–17); in order to have a substantial economic effect, a partner's allocation must be reflected in her capital account, and, in the event of a partnership liquidation, the liquidation proceeds must be distributed in accordance with the capital account balances. *Allison v. United States*, *supra* at 939; *Goldfine v. Commissioner*, *supra* at 852–853.[12] Moreover, where a partner's capital account reflects a deficit, she must have the obligation upon liquidation to restore the deficit. Absent such an obligation, the other partner or partners would have to bear part of the economic cost of the special

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[11] The Commissioner has filed proposed amendments to the regulations under sec. 704(b) as amended by the Tax Reform Act of 1976. Sec. 1.704–1(b), Proposed Income Tax Regs., 48 Fed. Reg. 9871 (Mar. 9, 1983). The proposed regulations were to be generally effective for partnership taxable years beginning after Dec. 31, 1983. However, the provisions of such regulations pertaining to the proper test for substantial economic effect were to be applicable for taxable years beginning after Dec. 31, 1975. The proposed regulations adopt the capital accounts analysis as the test of "economic effect," and consider other factors (those contained in the current regulations) only as a test of the "substantiality" of the economic effect. Sec. 1.704–1(b)(2), Proposed Income Tax Regs., *supra*.

[12] See also *Miller v. Commissioner*, T. C. Memo. 1984–336; *Hirsch v. Commissioner*, T. C. Memo. 1984–52; *Magaziner v. Commissioner*, T. C. Memo. 1978–205.

allocations that resulted in the deficit capital account. *Harris v. Commissioner*, 61 T.C. at 786; *Orrisch v. Commissioner*, 55 T.C. at 403–404.

In the present case, it is clear that the allocation to the petitioner of 22.8 percent of the third period's ratable share of Riverside's net loss lacked substantial economic effect. While the partnership agreement provided that the partners' capital accounts were to be adjusted for allocations of income, gain, loss, or deduction, the agreement specified that in the event of a liquidation or termination of the partnership, partners having deficit balances in their capital accounts would not be required to make up the deficits to the partnership or its creditors. Furthermore, the parties have stipulated (and the partnership agreement supports their stipulation) that partners having deficit balances would not receive a proportionately smaller share of partnership assets upon liquidation. Upon the sale of partnership property, the proceeds were to be distributed among the partners in the same percentages as their ownership of partnership stock, after the repayment of creditors and the payment of any arrearages in the Class B and Class C partners' "priority distribution rights." In addition, the petitioner, as a Class C partner in commendam, had a "priority distribution right" to the partnership's cash flow, and after the payment of priority distribution rights, cash flow was to be distributed on the basis of the partners' capital interests rather than on the basis of their capital accounts. Riverside's positive cash flow for 1979 and 1980 was, in fact, distributed in this manner. Riverside's proceeds from the refinancing of partnership debt were also distributed in accordance with the partners' capital interests. Thus, it is not only abundantly clear that under a capital accounts analysis the petitioner did not bear the economic burden of the special allocation to her, but it is also clear that the partners' capital accounts served no purpose beyond that of tax accounting.

The petitioner contends that the allocation to her had substantial economic effect even though it did not meet the requirements of a capital accounts analysis. She maintains that the capital accounts analysis overlooks two situations where special allocations can have substantial economic effect: first, where the profit and loss allocations are proportionate to the partners' capital interests; and second, where the partner-

ship agreement contains gain "charge back" provisions whereby partners with deficit balances in their capital accounts are allocated profits of the sale of property to bring their capital accounts to a positive balance. With respect to the first contention, the petitioner points out that she received a distributive share in 1978 of 1.87 percent of Riverside's total loss for the year, which, she contends, is slightly less than the 2-percent distributive share she would have received if the allocation had been based on her capital interest; therefore, she concludes that because the allocation was proportionate to her capital interest, she bore the economic burden of the allocation. We find the petitioner's first argument to be wholly without merit. In essence, she is maintaining that there was *no* special, or disproportionate, allocation to her in 1978, but this argument ignores the fact that petitioner did not have a 2-percent capital interest in Riverside throughout the entire year; the petitioner did not join the partnership until November. It is for that reason that the partnership prorated its net loss over the year to account for the varying capital interests of its partners. Clearly, the allocation to the petitioner of 22.8 percent of the third period's loss was disproportionate to the capital interest which she held at that time, and we have determined through analysis of the partnership agreement that she would not suffer any economic burden as a result of that disproportionate allocation.

The petitioner's second contention is equally without merit. As we observed in *Orrisch v. Commissioner*, 55 T.C. at 403, the effect of a "charge back" where the property is sold at a gain affects "only the tax liabilities of the partners and will have no other economic effect." We explained:

> The agreement in this case provided not only for the allocation of depreciation to petitioners but also for gain on the sale of the partnership property to be "charged back" to them. The charge back would cause the gain, for tax purposes, to be allocated on the books entirely to petitioners to the extent of the special allocation of depreciation, and their capital account would be correspondingly increased. The remainder of the gain, if any, would be shared equally by the partners. If the gain on the sale were to equal or exceed the depreciation specially allocated to petitioners, the increase in their capital account caused by the charge back would exactly equal the depreciation deductions previously allowed to them and the proceeds of the sale of the property would be divided equally. In such circumstances, the only effect of the allocation would be a trade of tax consequences, i.e., the

> Crisafis would relinquish a current depreciation deduction in exchange for exoneration from all or part of the capital gains tax when the property is sold, and petitioners would enjoy a larger current depreciation deduction but would assume a larger ultimate capital gains tax liability. * * * [55 T.C. at 403.]

We therefore concluded that "To find any economic effect of the special allocation agreement aside from its tax consequences, we must * * * look to see who is to bear the economic burden of the depreciation if the buildings should be sold for a sum less than their original cost." 55 T.C. at 403. Because there was no evidence that the petitioners in *Orrisch* would be required to contribute to the partnership a sum equal to the deficit in their capital account or would be entitled to receive a proportionately smaller share of partnership assets on liquidation, we held that the special allocation of depreciation lacked substantial economic effect. See also 1 W. McKee, W. Nelson & R. Whitmire, *supra* at par. 10.02[2][a], pp. 10–20 to 10–21 and n. 49. The depreciation "charge back" provision of Riverside's partnership agreement is similarly to be disregarded in assessing the economic substance of the special allocation to the petitioner; the significant facts in the present case, that partners having deficit balances in their capital accounts would not have to make them up and would not receive a proportionately smaller share of partnership assets on liquidation, are indistinguishable from those in *Orrisch*. Therefore, we conclude that the petitioner has failed to prove that the special allocation to her had a substantial economic effect.

The petitioner argues, in the alternative, that if the allocation to her was invalid for lack of substantial economic effect, the invalidity is limited to the amount by which the allocation exceeded her capital account balance of $35,600 in 1978. She submits that she "has borne the economic loss of $35,600, and, therefore, has a valid allocation to the extent of her capital contribution," and relies on an example in 1 W. McKee, W. Nelson & R. Whitmire, *supra* at par. 10.02[2][c], pp. 10–24 to 10–25. The authors of that treatise suggest that an allocation may have substantial economic effect in one year but lack it in the next. They observe that the regulations issued under prior law:

> apparently do not contemplate the possibility that an allocation provision may be valid in some years, but not in others. * * * This "all-or-nothing"

approach of the Regulation found support under the language of the original §704(b), which focused on the "principal purpose" of an allocation to determine its validity; the forbidden purpose could presumably exist even in years during which the allocation has substantial economic effect. [1 W. McKee, W. Nelson & R. Whitmire, *supra* at par. 10.02[2][c], p. 10–24.]

Because section 704(b) now provides that the partnership agreement, which may be amended during the year to alter distributive shares (section 761(c)), determines distributive shares unless the agreement lacks substantial economic effect, the treatise authors maintain that "Under present law, it seems that the validity of an allocation should be determined on an annual basis." They give the following as an example of an allocation which is valid in one year, yet lacks economic substance in the next year:

Example: In the CD partnership described in ¶10.02 [2][b] above, a special allocation of depreciation to D in year 1 eliminated his capital account. In year 2, a continuation of the special allocation produced a deficit in D's capital account. Even if D is not obligated to restore this deficit, thus invalidating the year 2 allocation, the year 1 allocation should be valid. [1 W. McKee, W. Nelson & R. Whitmire, *supra* at par. 10.02[2][c], pp. 10–24 to 10–25.]

Even if the special allocation to the petitioner was limited to the amount of her capital account in 1978 so that no deficit was created[13] the allocation still would lack substantial economic effect because, in the event of a liquidation, the proceeds would not be distributed on the basis of the partners' capital accounts. *Allison v. United States*, 701 F.2d at 939; *Goldfine v. Commissioner*, 80 T.C. at 852–853; 1 W. McKee, W. Nelson & R. Whitmire, *supra* at par. 10.02[2], p. 10–17, and at par. 10.06[1][a], p. 10–47. While the petitioner would receive a disproportionate share of the partnership's tax loss, she would not suffer any corresponding reduction in the dollars that she would receive upon liquidation.

Because the special allocation to the petitioner lacked substantial economic effect, we must redetermine her distributive share of Riverside's 1978 net loss "in accordance with * * * [her] *interest in the partnership (determined by taking into account all facts and circumstances)*." Sec. 704(b); empha-

[13] See *Dibble v. Commissioner*, T. C. Memo. 1984–589; sec. 1.704–1(b)(2)(ii), Proposed Income Tax Regs., 48 Fed. Reg. 9871 (Mar. 9, 1983).

sis added. "Among the relevant factors to be taken into account are the interests of the respective partners in profits and losses (if different from that of taxable income or loss), cash flow; and their rights to distributions of capital upon liquidation." S. Rept. 94–938, *supra*, 1976–3 C.B. (Vol. 3) at 138. The parties are essentially agreed that the petitioner's "interest in the partnership" is her 2-percent capital interest. However, the Commissioner would redetermine the petitioner's distributive share of the partnership's net loss by taking into account the fact that her capital interest varied over the course of the year; whereas, the petitioner claims that section 704(b) entitles her to a distributive share of 2 percent of the partnership's net loss without adjustment for her varying interest. We accept the Commissioner's computation as correct, and we hold that a partner's varying capital interest must be accounted for when redetermining the partner's distributive share in accordance with her "interest in the partnership" under section 704(b)(2). There is nothing in either the statutory language or legislative history of section 704(b)(2) to indicate that it was intended to override the requirements of section 706(c)(2)(B). The Commissioner's redetermination has properly implemented the purposes of both sections.[14]

Decision will be entered for the respondent.

GEORGE F. SMITH, JR., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 26787–82. Filed May 20, 1985.

Petitioner and a partnership of which he was a partner executed an "Assumption of Liability," by which petitioner purported to assume the obligation to pay principal and interest on a nonrecourse note executed by the partnership and secured by a deed of trust on property of the partnership. Thereafter, the

[14] In note 8, *supra*, we have set forth the method used by the Commissioner to compute the loss allowable to the petitioner. Since not all of the units for Class C partners were actually sold during the third period, the Commissioner determined that the petitioner's interest in the loss for that period actually exceeded 2 percent, and the petitioner has not challenged that computation.

partners exchanged their partnership interests for shares in a corporation in an exchange qualifying under sec. 351, I.R.C. 1954, the corporation assuming the partnership obligation to which the note was subordinated. *Held*:

1. Payments made by petitioner after the incorporation transaction, purporting to be interest on the note, are not deductible as interest under sec. 163(a), I.R.C. 1954, because the payments were not made on indebtedness;

2. The "Assumption of Liability" increased the basis in petitioner's partnership interest, as petitioner thereby took on ultimate liability on the note. For purposes of sec. 357(c), I.R.C. 1954, the corporation acquired the partnership interests subject to the note, and such liability, as among the partners, was petitioner's. Gain under sec. 357(c), I.R.C. 1954, determined.

James R. Murphy and *John C. Smuck*, for the petitioner.
Kristine A. Roth and *Marlene Gross*, for the respondent.

OPINION

TANNENWALD, *Judge*: Respondent determined the following deficiencies in and additions to petitioner's Federal income taxes:

Taxable year	*Deficiency*	*Addition to tax sec. 6653(a)*[1]
1976	$57,573.70	$2,878.69
1977	95.897.50	4,794.88
1978	373,930.89	18,696.54

The issues for decision are (1) whether petitioner may deduct as interest his payments made during 1978 with respect to a promissory note, and (2) whether petitioner must recognize gain on a series of transactions during 1978 culminating in the transfer of a partnership interest in exchange for stock in a controlled corporation.[2]

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue, and all Rule references are to the Rules of Practice and Procedure of this Court.

[2] The parties have stipulated that petitioner's deficiencies for 1976 and 1977 are $29,241.46 and $23,041.30, respectively; that petitioner's additions to tax under sec. 6653(a) for 1976 and 1977 are $1,462.07 and $1,152.07, respectively; and that petitioner's taxable income for 1978 is increased from $9,267 to $69,516, subject to adjustment for a net operating loss carryback from 1981 of $40,198.58 and to disposition of the two issues in the instant case. The parties further agreed that the addition to tax under sec. 6653(a) for 1978 will apply to the deficiency ultimately determined for 1978, without reference to any carryback.

The case was submitted fully stipulated under Rule 122. This reference incorporates the stipulation of facts and attached exhibits herein. At the time the petition was filed in this case, petitioner, a citizen of the United States, maintained his residence in Nassau, Bahamas. Petitioner timely filed Federal income tax returns for 1976, 1977, and 1978.

On July 7, 1971, petitioner and William R. Bernard (Bernard) entered into a partnership agreement establishing the Eleven Twenty Eight Sixteenth Co. (the partnership) for the purpose of purchasing and leasing the land and building located at 1128 16th Street, N.W., Washington, D.C. (the DC real property). In relevant part, the agreement provided as follows:

> 1. The partnership will be a general partnership and formed and operated under the laws of the District of Columbia.
>
> * * * * * * *
>
> 4. The profits and losses of the partnership shall be divided between the partners in accordance with the agreement of the partners.
>
> * * * * * * *
>
> 7. No obligations shall be incurred except with consent of both the partners.

On July 28, 1971, the partnership entered into a Contract of Sale and Indemnity Agreement (the purchase agreement) with the John H. Wilkins Co. (Wilkins) for the purchase of the DC real property. The purchase agreement provided, in relevant part, as follows:

> 2. The purchase price of land shall be One Hundred Thousand Dollars ($100,000.00) and the purchase price of the building thereon and the various fixtures thereto shall be Two Hundred Thousand Dollars ($200,000.00) * * * payable as follows:
>
> One Hundred Dollars ($100.00), by check subject to collection, receipt of which is hereby acknowledged.
>
> Two Hundred Ninety-nine Thousand Nine Hundred Dollars ($299,900.00) payable by the Purchaser, executing, acknowledging, and delivering to the Seller a negotiable promissory note satisfactory to the Seller and secured by a Deed of Trust on the properties herein sold and purchased, such note payable in one lump sum on the tenth (10th) yearly anniversary of settlement of this agreement together with any interest remaining unpaid and accrued thereon. * * * Said note shall bear interest at the rate of six and one-half percent (6½%) annually payable on the outstanding balance,

interest to be paid quarterly on the last day of each calendar quarter for the quarter or portion thereof then expiring except that no interest shall accrue or be payable for the first ninety (90) days subsequent to the date of closing. Said note shall be secured solely by the premises purchased. There shall be no personal obligation upon the Purchaser for the principal of or interest upon said note beyond the value of said premises, except as hereinafter provided, and Purchaser shall not be liable for any deficiency as to either principal or interest on said note beyond the value of said premises, in the event of foreclosure, default in interest payment, default in principal payment, or similar event other than for interest accrued to date of default or to date of disavowal of its obligation by the Purchaser plus such liquidation damages as hereinafter provided.

3. The Seller agrees that up to a maximum sum of One Hundred Twenty-five Thousand Dollars ($125,000.00), which the Purchaser may borrow from time to time from other sources, the lien of the Seller's purchase money mortgage created in Paragraph 2 hereto and the obligation of the note secured thereby shall be subordinated from time to time to funds which the Purchaser may borrow from time to time from other sources over a period of not more than three years from the date of closing from any source and apply to repairs, such as painting, plastering and otherwise, capital improvements, or expend on fixtures including but not limited to carpeting, draperies, blinds and lighting fixtures which shall attach to the property and form a part thereof.

The loan of such funds may be secured by a first Deed of Trust lien upon the premises to which the Seller's purchase money Deed of Trust shall be subordinated. The Purchaser agrees that upon default of any first trust outstanding against the premises, they shall inform the Seller of such default by written notice within ten (10) days.

4. The Purchaser agrees that upon default of either the senior indebtedness permitted under Paragraph 3 or the purchase money mortgage herein created the Purchaser will pay the Seller as liquidation damages the sum of:

(a) In the event that at the time of default there is any first trust outstanding against this property then; the larger of:

(1) Fifty Thousand Dollars ($50,000.00), or

(2) Fifty percent (50%) of the then outstanding balance of the senior indebtedness on said property permitted under Paragraph 3, and

(b) Six (6) months interest on the then outstanding balance of the purchase money mortgage created herein, and

(c) Provided the lease between the parties on the adjoining premises is outstanding at that time, the sum of Four Thousand Five Hundred Dollars ($4,500.00) representing six (6) months rent on the adjoining premises known as the "parking lot" and subject to a lease-option-agreement between the parties to this contract or their assigns.

The promissory note referred to in the purchase agreement (the Wilkins note) was secured by a deed of trust on the DC real property dated August 23, 1971.

From the time of the purchase by the partnership until the end of April 1978, the partnership conducted the business of rental of the DC real property, and Bernard, Joanne Crothers Bernard (Crothers), and several persons and entities related to petitioner contributed property (the Smith Co. assets) to the partnership in exchange for partnership interests. During this period, petitioner was a member of a law firm that occupied portions of the building located on the DC real property. For substantial portions of this period, Bernard and Crothers, husband and wife, were members of this law firm. By December 31, 1977, the senior obligation referred to in the purchase agreement appeared on the partnership's books as a note in favor of the NS & T Bank in the amount of $87,500, and the Wilkins note appeared in the amount of $299,900. Another partnership debt to NS & T Bank, in the amount of $5,995, also appeared on the partnership's books at this time.

In early 1978, pursuant to agreements reached by petitioner, Bernard, and Crothers in partial settlement of litigation arising out of disagreements between Bernard and Crothers, on the one hand, and petitioner, on the other hand, with respect to the conduct of the business of the law firm and the partnership, the Smith Co. assets were withdrawn in kind from the partnership, and steps were taken toward the incorporation of the partnership. After such withdrawal, petitioner's capital account stood at ($178,485.83), and that of Bernard and Crothers totaled ($1,711.78).

The partnership incurred an operating loss for the period January 1, 1978, through May 17, 1978, of $10,865, which petitioner claimed as a loss in 1978, and which loss respondent allowed. During the same period, petitioner made capital contributions to the partnership of $8,000.

On March 28, 1978, the parties to the litigation executed an agreement to settle the litigation whereby petitioner was to purchase the partnership interests of Bernard and Crothers for cash in the aggregate sum of $197,000, to be divided equally between Bernard and Crothers, in exchange for releases and a termination of the litigation. The payment was to be made "within ten (10) days of March 28, 1978, not to exceed thirty days thereafter."

On April 25, 1978, James R. Murphy became a partner in the partnership with an investment of $50,000. Thereafter on

the same day, petitioner paid Crothers and Bernard each $98,500, and Crothers and Bernard transferred their partnership interests to petitioner and executed and delivered a quitclaim deed to the DC real property in favor of petitioner.

On May 2, 1978, the partnership and Wilkins agreed that the amount to which the Wilkins note would be subordinated would be increased from $125,000, as provided in the purchase agreement, to $185,000. On the same date, the partnership executed a note, secured by a deed of trust on the DC real property, in favor of NS & T Bank in the principal amount of $185,000, payable in monthly $1,788 installments commencing June 2, with the unpaid principal balance and any accrued interest payable in 10 years. Petitioner personally guarantied this note.

On May 3, 1978, petitioner entered into a contract of sale with his mother, Minnie P. Smith, whereby Mrs. Smith agreed to purchase from petitioner the interests transferred to petitioner by Bernard and Crothers. Also on that date, petitioner entered into a contract of sale with a testamentary trust of his late father whereby the trust agreed to purchase from petitioner a 25-percent capital interest in the partnership.[3]

On May 11, 1978, petitioner executed and contributed to the partnership a document entitled "Assumption of Liability," which provided, in relevant part:

> WHEREAS, George F. Smith, Jr., a general partner [illegible] the Eleven Twenty Eight Sixteenth Company, is willing to personally [illegible]ume the obligation to pay the $299,900.00 due to the John H. Wilkins [illegible]ompany;
>
> NOW THEREFORE, in consideration of $1.00 pai[illegible] nand and other good and valuable consideration receipt of which is m[illegible]ally acknowledged, the undersigned hereby agree that from this date fo[illegible]rd George F. Smith, Jr., promises to pay the $299,900.00 second mortgage created by the aforesaid agreement of July 28, 1971 along with all interest chargeable to that portion of the second mortgage as said interest comes due.

Petitioner signed the agreement on his own behalf and for the partnership. On the same date, petitioner withdrew from the partnership $95,515, representing substantially the net proceeds of the $185,000 note to NS & T Bank after satisfaction of the unpaid balance of the original $125,000 senior obligation.

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[3] Although the record does not so reveal, the parties have based their positions herein on the assumption that the contracts of sale were closed, and we will do the same.

At the time of the execution of the Assumption of Liability, the $185,000 senior indebtedness was outstanding, as was the parking lot lease referred to in the purchase agreement. Thus, the "liquidation damages" under the purchase agreement at the time of such execution would amount to $106,746.75, representing 50 percent of the outstanding senior debt ($92,500), plus 6 months interest on the Wilkins note balance ($9,746.75), plus 6 months rent on the parking lot lease ($4,500).

Following the execution of the Assumption of Liability, the financial position of the partnership stood as follows:

Assets		*Liabilities and capital*	
Land and building	$797,000	First trust	$185,000
Cash and miscellaneous	12,100	Miscellaneous	12,100
		Net worth	612,000
	809,100		809,100

The DC real property remained subject to the $299,900 Wilkins note, for which the partnership held petitioner's agreement to pay. In estimating the $797,000 fair market value of the DC real property, the partnership relied on a March 1978 offer by an unrelated party for a 10-year lease on the property, with an option to purchase after 3 or 10 years for the inflation-adjusted equivalent of $825,000.

On May 17, 1978, the four partners contributed their partnership interests to the Eleven Twenty Eight Sixteenth Corp. (the corporation), which was formed on March 26, 1978, in exchange for $100 par value common stock having a fair market value of $1,000 per share. The stock was issued in the following amounts and proportions:

Partner	*Shares*	*Percent*
Petitioner	204	33%
Minnie P. Smith	208	34
Trust	150	25
Murphy	50	8

The corporation simultaneously assumed the $185,000 first trust indebtedness to NS & T Bank. The corporation made the 1978 interest payments on the $299,900 Wilkins second trust note, but, with respect to payments after May 17, the payments were charged on the corporate books to reduce the

balance due petitioner from the corporation on prior advances. In this way, petitioner made payments in respect of the Wilkins note on June 30 and October 1 of $4,913.43 each, and such payments were considered by Wilkins to be interest. Thereafter, until the note was paid, petitioner made all payments of the interest on the Wilkins note personally.

Basic to our resolution of the issues herein is a determination as to the validity of the assumption agreement between petitioner and the partnership. Neither party disputes the proposition that this determination rests upon State law—in this case the law of the District of Columbia. *Walther v. Commissioner*, 316 F.2d 708 (7th Cir. 1963), revg. a Memorandum Opinion of this Court (only *on the application* of the governing State law); *Arrigoni v. Commissioner*, 73 T.C. 792 (1980); *Abdalla v. Commissioner*, 69 T.C. 697, 707 (1978), affd. 647 F.2d 487 (5th Cir. 1981).

The record herein is lacking in precise information as to the circumstances surrounding petitioner's assumption of the obligation of the partnership to Wilkins. The stipulation of facts, which provides the only evidence of record, merely states: "On May 11, 1978, petitioner on his own behalf and on behalf [of] the partnership executed and contributed to the partnership a document entitled Assumption of Liability. A copy of said document is incorporated as Exhibit 20-T." That exhibit merely sets forth the "assumption" by petitioner. On brief, petitioner asserts that "under his assumption agreement, petitioner acquired an additional investment interest in the partnership for which he received shares in the corporation." In his reply brief, respondent accepts this characterization and indicates that it is the basis of respondent's claim herein that the payments under the assumption agreement were contributions to the partnership and/or the corporation. In view of the foregoing, we will assume that there was sufficient consideration to support petitioner's assumption of the partnership's obligation to Wilkins. Clearly, the assumption, in turn, supplied sufficient consideration for petitioner's increased partnership interest. We recognize that because the partnership was a nonrecourse obligor, there may be a question under District of Columbia law as to the nature of petitioner's obligation, i.e., whether he had any obligation to Wilkins as a third-party beneficiary. Compare *Yasuna v.*

Miller, 399 A.2d 68 (D.C. 1979), with *DeLeon v. Rhines*, 74 F.2d 477 (D.C. Cir. 1934). But there is nothing in the law of the District of Columbia to suggest that petitioner was not liable to the partnership, and thereafter to the corporation, i.e., in the event of foreclosure, even though he may not have been liable to Wilkins.

The first issue for decision is whether petitioner is entitled to an interest deduction for the $9,826.86 paid in 1978, purportedly as interest on the Wilkins note. Section 163(a) allows as a deduction "all interest paid or accrued within the taxable year on indebtedness," and it is well settled that the indebtedness must be that of the taxpayer taking the deduction. *Southern Pacific Transportation Co. v. Commissioner*, 75 T.C. 497, 565 (1980); *Rushing v. Commissioner*, 58 T.C. 996, 1000 (1972). It is also well settled that to be a payment "on indebtedness," a payment must be for the use or forbearance of money. *Deputy v. du Pont*, 308 U.S. 488, 497 (1940); *Dean v. Commissioner*, 83 T.C. 56, 57 (1984). To effectuate these standards, this Court has stated that the interest deduction is allowable only where the payor's liability at the time of payment is primary and direct, see, e.g., *Hynes v. Commissioner*, 74 T.C. 1266, 1287–1288 (1980); however, it must be remembered that the primary and direct liability must be "on indebtedness," i.e., the payment must be made pursuant to an agreement providing either for the use of money by the payor or for the forbearance of enforcement of a money obligation of the payor.[4] See *Abdalla v. Commissioner*, 647 F.2d 487, 503–504 (5th Cir. 1981), affg. 69 T.C. 697, 707 (1978).

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[4] The regulations have been said to provide an exception to the requirement of primary and direct liability on indebtedness—

"Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness. [Sec. 1.163-1(b). Income Tax Regs.]"

See *Rushing v. Commissioner*, 58 T.C. 996, 1000 (1972). However, this provision is not an exception to the rule stated in text, but is designed to recognize the "economic substance of nonrecourse borrowing," i.e., that default would affect only the person who would lose the securing property. *Golder v. Commissioner*, 604 F.2d 34, 36 (9th Cir. 1979), affg. a Memorandum Opinion of this Court; *Hynes v. Commissioner*, 74 T.C. 1266, 1288 (1980). Thus, the "exception" can be seen as a corollary: when *property owned by the taxpayer* secures a note on which the taxpayer pays interest, the interest payment is made under an agreement providing for the taxpayer's use of the money originally loaned in connection with the sale of the property. See *New McDermott, Inc. v. Commissioner*, 44 B.T.A. 1035, 1040–1041 (1941); see also *Golder v. Commissioner, supra* at 36 n. 1.

Thus, the deduction has been denied where the taxpayer paid interest on behalf of his corporation,even where the loan was executed by the taxpayer in his capacity as a corporate officer and the loan proceeds inured to the personal benefit of the taxpayer, as the taxpayer was not primarily and directly liable on the indebtedness. See *Golder v. Commissioner*, 604 F.2d 34 (9th Cir. 1979), affg. a Memorandum Opinion of this Court; *Reese v. Commissioner*, T.C. Memo. 1976–275, affd. on another ground 615 F.2d 226 (5th Cir. 1980). Moreover, a guarantor making an interest payment required due to a default by the debtor has been denied the deduction, as the obligation pursuant to which the guarantor pays interest is not the payor's debt obligation, but a guaranty agreement concerning another's debt obligation. *B.B. Rider Corp. v. Commissioner*, 725 F.2d 945, 950 (3d Cir. 1984); *Southern Pacific Transportation Co. v. Commissioner, supra* at 565; *Hynes v. Commissioner, supra* at 1287–1288.[5] However, a joint obligor who pays interest on the obligation may deduct such payment, as the payor is primarily and directly liable under his or her agreement for the use of money. See *Arrigoni v. Commissioner*, 73 T.C. 792, 806 (1980); *Williams v. Commissioner*, 3 T.C. 200, 202 (1944).[6]

At the time of the instant interest payments, the situation regarding the Wilkins note can be summarized as follows: The $299,900 Wilkins note was secured by a deed of trust on the DC real property, was without recourse to the partnership except to the extent of the "liquidation damages" specified in the purchase agreement as payable in the event of default on either the note or the senior indebtedness, and was subordinated to the $185,000 NS & T note, which was also secured by a deed of trust on the DC real property. Petitioner had personally guarantied the NS & T note, and had purported to

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[5] Compare *Stratmore v. Commissioner*, T.C. Memo. 1984–547, with *Tolzman v. Commissioner*, T.C. Memo. 1981–689.

[6] This result has been called "anomalous" because joint obligors are presumably entitled to contribution against those joint obligors who do not pay their pro-rata share of the liability. See Asimow, "Failure to Establish a Debt as That of the Taxpayer Will Bar an Interest Deduction," 6 Taxation for Lawyers 230, 232 (1978). However, payments on a debt obligation on which the payor is primarily and directly liable satisfy sec. 163 irrespective of the fact that the *ultimate* liability on the debt falls on someone other than the payor. See *Mason v. United States*, 453 F. Supp. 845, 848–849 (N.D. Cal. 1978). But cf. *Abdalla v. Commissioner*, 69 T.C. 697, 707 (1978), affd. 647 F.2d 487, 503–504 (5th Cir. 1981), where the deduction was denied to a taxpayer who became directly liable to the creditor by virtue of local statutory provisions, which also gave the taxpayer full recourse against the other obligor.

assume the payment obligations on the Wilkins note as of May 11, 1978. The corporation had assumed the NS & T note obligation.

Petitioner argues that his assumption of the Wilkins note obligation transformed the partnership's nonrecourse[7] obligation into his personal recourse obligation, and contends that he was thus the primary debtor at the time of the interest payment. The corporation would, according to petitioner, be rightly denied the deduction in this situation. Respondent, characterizing the "assumption" as nothing more than an indirect obligation to make future capital contributions, argues that an assumption agreement works to transfer an indebtedness, for purposes of section 163, only where a grantee assumes mortgage liability upon transfer of the securing property from the mortgagor to the grantee. In any event, respondent asserts, the rights of mortgagee Wilkins cannot be changed even by a valid assumption, and these rights are only to the securing property plus the "liquidation damages."

The original debt agreement established the Wilkins note as an obligation running in substance between the creditor and the securing property. At that point, then, the only possible payor of deductible interest was the owner of the property, i.e., the partnership. See *supra* note 4. Petitioner's assumption, executed between himself and the partnership, was of a liability that was for the most part without recourse to the partnership. While in a mortgage-law sense, this agreement may merely have expanded the remedy of the creditor to include petitioner personally, a question under local law we find it unnecessary to address (see *supra* p. 896), in the context of section 163, the assumption created a new obligation, different from the underlying agreement for the use of money. Because of the inadequacy of the record herein as to the circumstances surrounding petitioner's assumption of liability (see *supra* p. 896), we cannot find that petitioner has carried his burden of proof (see Rule 142) that, in substance, this new obligation running between petitioner and the partnership should not be viewed either as an agreement to indemnify the partnership for its payments of principal and interest on the

[7] On brief, petitioner acknowledges that, despite the contingent personal liability arising from the "liquidation damages" clause, "the Wilkins obligation fits most closely within the definition and concept of a non-recourse mortgage."

note or as an agreement to contribute to the capital of the partnership, and subsequently of the corporation, any amounts needed to make those payments. In either case, petitioner's "interest" payments were made not in consideration of any right of petitioner to use money or to avoid enforcement by Wilkins of a money obligation of petitioner, but rather as consideration for an increased partnership interest. See *supra* p. 896.[8] Although Wilkins may, under local third-party beneficiary law, have had a cause of action against petitioner in the event petitioner failed to make the payments in question, petitioner's liability, i.e., his legal incentive to make the payments, would arise under the separate assumption agreement, and not an indebtedness agreement. Moreover, the provision for "liquidation damages" is of no avail to petitioner. Although the partnership's obligation to pay damages in the event of default in an amount equal to $106,745.75 at the time of petitioner's assumption was with full recourse, and such assumption therefore made petitioner an additional obligor thereon (see *Yasuna v. Miller, supra* at 73–74), any payments of "interest" as to this obligation were not for the use or forbearance of money, and, as noted above, are thus not deductible.

In short, despite the fact that petitioner was apparently ultimately liable for the payment of the sums represented by the Wilkins note, including interest, i.e., either as the partnership's and therefore the corporation's indemnitor or pursuant to a promise to make future contributions to capital,[9] in making the payments in question, petitioner was neither discharging a personal obligation of the partnership undertaken in respect of the money advanced by Wilkins nor protecting his use of the property securing that obligation.[10] Consequent-

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[8] We note that, given more evidence, it is conceivable that a taxpayer in petitioner's position could convince us that he or she in substance borrowed money from the partnership to buy an increased partnership interest, and paid interest on *that* debt through the partnership to Wilkins, thus being entitled to an interest deduction and giving the partnership both interest income and an interest deduction. The record herein, however, does not support such a characterization.

[9] See *supra* note 6. Compare also the cases dealing with transferor-shareholders' warranties against liabilities of a corporation. *Leward Cotton Mills, Inc. v. Commissioner*, 245 F.2d 314 (4th Cir. 1957), revg. 26 T.C. 885 (1956); *Central Electric & Gas Co. v. United States*, 159 F. Supp. 353 (Ct. Cl. 1958); *Hanna Furnace Corp. v. Kavanagh*, an unreported case (E.D. Mich. 1950, 42 AFTR 1312, 50-2 USTC par 9443).

[10] Different considerations would apply, however, if either (1) the creditor had recourse to the prior obligor on the debt before the assumption or (2) the assuming party also acquired the securing property. The assumption in the former situation, rather than creating an obligation for

ly, even though petitioner may have been liable primarily and directly to Wilkins (see *supra* p. 896), he has not met the additional "on indebtedness" requirement of section 163. Accordingly, petitioner is not entitled to deduct those payments as interest.[11]

The remaining issue concerns the amount of gain recognized on the transfer of petitioner's partnership interest for stock in the corporation. Section 351(a) provides nonrecognition treatment for transfers of property solely in exchange for stock or securities of a controlled corporation, subject to the special rule found is section 357(c) for assumptions of liabilities. Sec. 351(f)(1). Section 357(a) provides that where, as part of a section 351 exchange, another party assumes a liability of, or acquires property subject to a liability from, the transferor, such assumption or acquisition will not run afoul of the "solely in exchange for stock or securities" requirement in section 351. However, section 357(c)(1) requires recognition of gain to the extent that "the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred" pursuant to the section 351 exchange.

In the instant case, petitioner transferred his interest in the partnership to the corporation in exchange for stock, the corporation assuming the partnership's $185,000 senior debt and succeeding to the partnership's interest in the DC real property.[12] As the gain provision of section 357(c) is to be

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tax purposes that did not exist under the debt agreement, would merely place the assuming party in the position of the original obligor as regards the use or forbearance of money. Payments by the assuming party would thus be made pursuant to the original debt agreement, and would thus be "on indebtedness." In the latter situation, the policy enunciated in sec. 1.163-1(b), Income Tax Regs., would require allowance of the interest deduction in recognition of the economic substance of the nonrecourse debt. See *supra* note 4. In the instant case, in addition to the creation of a new obligation under which the "interest" payments were made, the assumption agreement did not change the fact that because the encumbered title to the DC real property was at all times held by the partnership entity (see D.C. Code sec. 41-107 (1981)), the partnership (and the corporation as its successor), and not petitioner, would be directly affected by a default on the debt obligation.

[11] We note that the fact that the payment in question constituted interest income to Wilkins has no bearing on this issue. See *Investors Insurance Agency v. Commissioner*, 72 T.C. 1027 (1979), affd. 677 F.2d 1328 (9th Cir. 1982).

[12] The stipulation of facts states only that the corporation assumed the $185,000 senior indebtedness; it is silent as to the obligation to Wilkins. However, the parties have argued the case on the basis that the corporation at most merely took the DC real property subject to the obligation to Wilkins and did not assume any recourse liability with respect thereto. For purposes of decision herein, we accept the factual basis of the parties' argument.

applied separately to each section 351 transferor (see Rev. Rul. 66–142, 1966–1 C.B. 66), we must determine both (1) the adjusted basis of petitioner's partnership interest immediately before the section 351 exchange, and (2) petitioner's share of the liabilities assumed by the corporation and those subject to which the corporation acquired the partnership interests (the section 357(c) liabilities).

We turn first to the question of the adjusted basis of petitioner's interest in the partnership transferred to the corporation in the incorporation transaction. Such basis may be calculated by reference to the relevant portions of sections 722, 752, and 705(a).

Section 722 provides that the basis of a partnership interest acquired by contribution of property, including money, is "the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution." Section 752(a) deems as a contribution of money, for purposes of section 722, "Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities." Section 705(a) adjusts the adjusted basis of the partner's interest as determined under section 722 by increasing such basis by the partner's distributive share of partnership income, and decreasing such basis (but not below zero) by distributions by the partnership and by the partner's distributive share of partnership losses. See also sec. 733. Section 752(b) deems as a distribution of money, for purposes of section 705(a), "Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities." For purposes of section 752, "a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property." Sec. 752(c).

The parties, while disagreeing on many aspects of the basis calculation, appear to agree that petitioner's basis in the partnership at the beginning of 1978, before consideration of the Wilkins and NS & T liabilities and the withdrawal of the Smith Co. assets, was zero. The first item on which there is disagreement is the partnership liabilities. As of January 1,

1978, the partnership had obligations in the principal amounts of $87,500 and $5,995 to NS & T Bank, and $299,900 to Wilkins. A partner's share of the partnership liabilities, for purposes of section 752, is to be "determined in accordance with his ratio for sharing losses under the partnership agreement." Sec. 1.752–1(e), Income Tax Regs. However,

> where none of the partners have *any* personal liability with respect to a partnership liability (*as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage*), then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits. [Sec. 1.752–1(e), Income Tax Regs.; emphasis added.]

In the District of Columbia, the partnership agreement controls the partners' shares of profits and losses. D.C. Code Ann. sec. 41–117(1) (1981).[13]

In the instant case, the partnership agreement simply allocates profits and losses "in accordance with the agreement of the parties." As petitioner deducted the full partnership loss for the first part of 1978, the partners then in place appear implicitly to have agreed to allocate 100 percent of partnership losses to petitioner, and respondent does not dispute this allocation. As NS & T Bank presumably had recourse to the partnership as to the $5,995 unsecured note and the $87,500 secured note, petitioner correctly added the full $5,995 and $87,500 to his basis. Secs. 752(a), 722. With respect to the Wilkins note in the amount of $299,900, the requirements of the portion of section 1.752–1(e), Income Tax Regs., *supra*, dealing with nonrecourse liability have not been met, as the partnership had assumed *some* recourse liability on that obligation, i.e., the "liquidation damages."[14] Thus, the loss

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[13] "The rights and duties of the parties in relation to the partnership shall be determined, *subject to any agreement between them*, by the following rules:

"Each partner shall * * * share equally in the profits and surplus remaining after all liabilities, including those to partners, are satisfied; and must contribute toward the losses, whether of capital or otherwise, sustained by the partnership according to his share in the profits * * * [D.C. Code Ann. sec. 41–117(1) (1981); emphasis added.]"

[14] Cf. *Laney v. Commissioner*, 674 F.2d 342, 348–349 (5th Cir. 1982), affg. on this issue a Memorandum Opinion of this Court (partner's retained personal liability renders note recourse, for purposes of sec. 1.752–1(e), Income Tax Regs.); Rev. Rul. 83–151, 1983–2 C.B. 105; H. Rept. 98–861 (Conf.) (1984), 1984–3 C.B. (Vol. 2) 1, 122–123 (explaining that Pub. L. 98–369, sec. 79, 98 Stat. 597 (1984), overruling *Raphan v. United States*, 3 Cl. Ct. 457 (1983), revd. on this issue 759 F.2d 879, 887 (Fed. Cir. 1985), requires that notes on which a partner is primarily or secondarily liable be characterized as recourse, for purposes of sec. 1.752–1(e), Income Tax Regs, *supra*).

allocation percentage applies, and petitioner's basis is increased by the full principal amount of the partnership obligations.

The parties agree that the withdrawal of the Smith Co. assets decreased the basis in petitioner's partnership interest by $178,485.83 (secs. 705(a), 733), that petitioner's deduction of the partnership operating loss decreased his basis by $10,865 (sec. 705(a)), and that petitioner's capital contribution increased his basis by $8,000 (sec. 722). Thus, before any partnership interests changed hands, petitioner's basis was $212,044.17, and his share of the partnership liabilities was $393,395. For the detailed calculation of petitioner's basis and share of liabilities, see Appendix, pages 911–912.

Respondent argues that, upon Murphy's purchase of a partnership interest for $50,000, petitioner's share of the partnership liabilities decreased because any implicit agreement among petitioner, Bernard, and Crothers regarding the allocation of losses to petitioner does not necessarily apply to new partners. We agree. Moreover, neither in his original nor his reply brief, does petitioner appear to contest this element of respondent's position herein. Once Murphy became a member of the partnership, there was no "agreement of the partners" as to loss allocation, and the partnership agreement thus ceased to provide for such allocation. Thus, section 704(b)(1) comes into play, and, for tax purposes, petitioner's "distributive share of * * * loss * * * shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances)."[15] The only indication in the record of just how much of an interest Murphy purchased is that upon incorporation, Murphy received 8 percent of the shares of the corporation. Under these circumstances, and in the absence of any other explanation by respondent of his use of 10 percent, we hold that Murphy was, under section 704(b)(1), entitled to share in partnership losses to the extent of 8 percent and that petitioner's share of the liabilities, and thus his basis, decreased by $31,471.60 (.08 × $393,395) when Murphy became a partner. See secs. 752(b), 705(a); cf. *Richardson v. Commissioner*, 76 T.C. 512, 528–530 (1981), affd. 693 F.2d 1189 (5th Cir. 1982).

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[15] For the default provision for purposes of State (i.e., District of Columbia) law, see *supra* note 13.

Petitioner, then, owned 92 percent of the partnership after buying the interests of Bernard and Crothers for $197,000. This buy-out increased petitioner's basis by the $197,000 cost of the interest. See sec. 742. There is no increase in petitioner's share of the liabilities, as no part of the partnership liabilities was allocated to Bernard and Crothers under the agreement of the partners.

Petitioner's basis also increased when the partnership refinanced the old NS & T note with a new senior trust indebtedness of $185,000. Since, for aught that appears, this note was a recourse obligation of the partnership, the loss allocation percentage controls. That petitioner guarantied this note does not change its characterization as a liability of the partnership. *Proesel v. Commissioner*, 77 T.C. 992, 1004 (1981); see Volet & Millman, "Liability Assumption Under Section 752: An Analysis of the Underlying Theory," 60 J. Tax. 374, 376 (1984). Thus, since Murphy had an 8-percent interest in the partnership, petitioner's basis increased by $170,200 (.92 × $185,000) when the partnership incurred the new obligation, and decreased by $80,500 (.92 × $87,500) since the new obligation replaced the old note, which in fact was paid off pursuant to the refinancing. At this point, petitioner's basis in the partnership was $467,272.57, and his share of the partnership liabilities was $451,623.40.

Petitioner next sold the partnership interests of Bernard and Crothers to Minnie Smith. The parties agree that petitioner's basis decreased by the $197,000 interest transferred. Petitioner, however, fails to take account of the share of the partnership liabilities transferred to Mrs. Smith as part of the transaction. Again, once new partners joined the partnership, the implicit agreement to allocate losses no longer existed, and section 704(b)(1) operates to allocate losses, and thus partnership liabilities, on the basis of the partners' interests in the partnership. Once again looking forward to the incorporation, we see that petitioner and Mrs. Smith ended up with approximately equal numbers of shares. Thus, we find that petitioner, in selling the Bernard and Crothers interests to Mrs. Smith, transferred one-half of his 92-percent interest,[16] resulting in a

[16] This result is supported by the fact that petitioner stated on brief that his agreement to pay $197,000 for the Bernard and Crothers interests "evidences a de facto agreement" that such interests represented a 50-percent profits interest, as $197,000 approximates 50 percent of the then net worth of the partnership ($403,605, i.e., $797,000 - $393,395).

reduction of his share of the partnership liabilities, and thus of his basis, of $225,811.70 (.50 × $451,623.40). See secs. 752(b), 705(a); cf. *O'Brien v. Commissioner*, 77 T.C. 113, 116–118 (1981).

The trust then purchased from petitioner "a 25 percent capital interest in the partnership." Before this transaction, petitioner's basis stood at $44,460.87. Petitioner argues that this 25-percent interest had no basis, while respondent would *increase* petitioner's basis as a result of the sale, arguing that petitioner transferred 25 percent of a partnership interest that then had a negative basis. To begin with, section 705(a) specifically forbids the use of a negative basis in the computation of the basis of a partnership interest. See also sec. 733. Moreover, petitioner transferred to the trust *a 25-percent interest* in the partnership, not 25 percent of *his* interest in the partnership. Thus, as petitioner held a 46-percent interest in the partnership after the sale to Mrs. Smith (i.e., one half of 92 percent), he would have had to transfer 54.3 percent (.25/.46) of his 46-percent interest to give the trust a 25-percent interest in the partnership. Petitioner's basis, then, decreased by $24,142.25 (.543 × $44,460.87) to reflect the transferred interest, and $122,615.75 (.543 × $225,811.70) to reflect the lost share of liabilities. However, since petitioner's basis could be reduced only to zero, only $20,318.62 of the latter basis reduction could be used.[17] Petitioner's basis at this point was thus zero, and his share of the partnership liabilities was $103,195.95.

Petitioner next executed the "Assumption of Liability" agreement regarding the $299,900 Wilkins note. We have already held, in the context of the interest deduction, that the payments under this agreement were not interest "on indebtedness" within the meaning of section 163. The question now is whether the agreement was effective to increase petitioner's liabilities for purposes of section 752(a), i.e., whether the "assumption" was an "assumption by such partner of partner-

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[17] We note that, although respondent did not argue this point, the remaining $102,297.13 is deemed a money distribution to petitioner under sec. 752(b) not only for purposes of sec. 705(a), but also for purposes of sec. 731(a)(1), under which gain is to be recognized "to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution." See *Richardson v. Commissioner*, 76 T.C. 512, 528–530 (1981), affd. 693 F.2d 1189 (5th Cir. 1982); *O'Brien v. Commissioner*, 77 T.C. 113, 116–117 (1981). As respondent did not address the sec. 731 implications of the share of liabilities transferred to the trust, however, we decline to impose our analysis or its resulting tax consequences on petitioner.

ship liabilities." As indicated above, the substance of petitioner's assumption is that the partnership continued to be at risk as to the securing property, and petitioner was liable to the partnership (and later to the corporation) as an indemnitor (or under an obligation to make contributions to capital) for any loss sustained in the event of default. Thus, although the partnership property was still subject to foreclosure if the mortgage was not paid, the ultimate liability fell upon petitioner.

The regulations give the following example of the application of section 752(a)—

> equal partnership AB owns real property with an adjusted basis to the partnership of $1,000, a fair market value of $800, and which is subject to a mortgage of $400 which the partnership has not assumed. The mortgage is considered as a liability of the partnership under section 752(c). Since A and B each share one-half thereof, under section 752(a) the liability of each has been increased $200. Under section 722 such $200 increase is reflected in the basis of each partner for his interest. The real property is distributed by the partnership to A. Under the provisions of section 733(2), there is a net decrease of $800 in A's basis for his partnership interest. This amount is computed as follows: *The basis of A's partnership interest is* decreased in the distribution by $1,000 (the partnership basis for the distributed property) and further decreased under section 752(b) by $200 (the decrease in A's share of partnership liabilities) and *increased under section 752(a) by $400 (the increase in A's individual liability by reason of section 752(c)).* [Sec. 1.752-1(a)(2), Income Tax Regs.; emphasis added.]

Thus, respondent has recognized that ultimate liability is the test under section 752; in this example, the property is in the hands of A, and the partnership, in whose hands the property was originally liable to the mortgagee, has no further responsibility in respect of the mortgage obligation. A's basis is increased irrespective of the fact that the mortgagee was not a party to the transaction.

We think that the same reasoning should apply in the instant case. To be sure, the partnership herein retained the property and thus was, in the first instance, exposed to the risk of foreclosure. In that event, however, the partnership could look to petitioner, who had an unconditional obligation to make the partnership whole by virtue of the assumption agreement. Section 752 provides for the constructive contribution of cash in order to treat a partner who assumes an obligation of the partnership exactly as if he or she had given

the partnership the money with which to discharge the debt. See *Long v. Commissioner* 71 T.C. 1, 9 (1978), remanded on other issues 660 F.2d 416 (10th Cir. 1981). Where, as here, the partner becomes ultimately liable to pay the debt, it is irrelevant for purposes of section 752(a) that the partnership or its property remains liable to the mortgagee. See Volet & Millman, *supra* at 376; cf. *Long v. Commissioner*, *supra* at 8–10; G.C.M. 35627 (Jan. 16. 1974); compare Rev. Rul. 69–223, 1969–2 C.B. 184, with Private Letter Rul. 8404012 (Oct. 13, 1983). But cf. *Danoff v. United States*, 499 F. Supp. 20 (M.D. Pa. 1979).[18] By taking on ultimate and unconditional liability, petitioner constructively contributed the amount of the indebtedness to the partnership, and was thus entitled to increase his basis by $236,921 (i.e., his basis increased by the full $299,900 individual liability and decreased by his share of the partnership's former liability, $62,979 (.21 × $299,900)).

Finally, petitioner withdrew $95,515 from the partnership. At the time of this distribution, petitioner's basis was $236,921. Thus, the section 731 issue with respect to this distribution, raised by respondent for the first time on brief, is moot, and, under sections 733 and 705(a)(2), petitioner's basis immediately before the incorporation was $141,406 ($236,921 less $95,515).

Now that we have determined petitioner's basis in the partnership immediately before the incorporation transaction, computation of section 357(c) gain requires a determination of (1) the amount of the section 357(c) liabilities, i.e., those assumed by, or to which property was taken subject by, the corporation, and (2) petitioner's share of such liabilities. The parties agree that the $185,000 note, assumed by the corporation, qualifies as a section 357(c) liability. However, petitioner contends that *his* assumption of the $299,900 obligation takes

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[18] We note that, for purposes of sec. 752, petitioner's status either as an indemnitor of the partnership or as one obligated to make capital contributions thereto, i.e., having no rights over against the partnership or other parties, is different from that of a guarantor, who has a contractual right over against the defaulting party, and is thus not ultimately liable. See Volet & Millman, "Liability Assumption Under Section 752: An Analysis of the Underlying Theory," 60 J. Tax. 374, 376 (1984). In the latter situation, the basis of guarantor-partner's partnership interest is not increased by the amount of the partnership debt guarantied. See *Proesel v. Commissioner*, 77 T.C. 992, 1004 (1981). The conclusion in *Raphan v. United States*, 759 F.2d 879, 886 (Fed. Cir. 1985), revg. on this issue 3 Cl. Ct. 457 (1983), is only that *limited* partners do not share in debt guarantied by a general partner; the court did not have before it the question of to which of the *general* partners such debt is allocated.

that debt outside the realm of section 357(c). In petitioner's view, as petitioner transferred to the corporation his unencumbered partnership interest, there is no liability to which section 357(c) can be said to apply. We disagree.

The question of the effect of petitioner's assumption for purposes of determining the amount of the section 357(c) liabilities is different from that of its effect for purposes of either section 163 or section 752(a). While, as previously noted, section 163 requires that petitioner be primarily and directly liable "on indebtedness," and section 752(a) requires that petitioner undertake ultimate liability on the obligation, section 357(c) requires only that the corporation take the property acquired in the exchange subject to the obligation. Generally, a transfer subject to a mortgage is an agreement that, as between the transferee and the transferor, the debt is to be satisfied out of the land. G. Osborne, Mortgages 507 (2d ed. 1970). So long as the transferred property remains liable on the debt, then, such debt can be a section 357(c) liability even if petitioner retained personal, unrelieved liability on it. *Rosen v. Commissioner*, 62 T.C. 11, 19 (1974), affd. without published opinion 515 F.2d 507 (3d Cir. 1975); see DeBerry, "Current Problems With the Assumption of Liabilities in Incorporation Transactions," N.Y.U. 37th Inst. on Fed. Tax. (Part 1) 4–1, 4–6 to 4–7 (1979).[19] In fact, we have held that a pre-incorporation paper transaction making the excess of liabilities assumed by the corporation over the basis of the assets transferred personal liabilities of the transferor does not remove the liabilities from section 357(c). *Alderman v. Commissioner*, 55 T.C. 662 (1971).

In the instant case, petitioner's assumption, although placing ultimate liability on petitioner to make the partnership (and its corporate successor) whole in the event of foreclosure, did not change the fact that the DC real property was liable to Wilkins on the note.[20] Petitioner argues that the $299,900 debt

[19] See also *Beaver v. Commissioner*, T.C. Memo. 1980–429. But cf. *Jackson v. Commissioner*, 708 F.2d 1402 (9th Cir. 1983), revg. a Memorandum Opinion of this Court (continuing liability of transferor, so no sec. 1001 exchange; no sec. 357(c) liabilities, as the only liability involved could not legally have been assumed), questioned in 1 W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners, par. 6.03, at 86–4 n. 35.1 (Supp. 1984).

[20] Although it is possible that Wilkins would, under District law, have a direct claim against petitioner as a third-party creditor beneficiary (see *supra* p. 896), the fact remains that the creditor could choose to enforce his contractual right against the property upon default. Thus, the DC real property was transferred subject to the mortgage.

is not a section 357(c) liability because the corporation acquired the partnership *interests*, and not its *assets*. Thus, according to petitioner, the property actually transferred was not subject to the Wilkins note obligation. The cases cited by petitioner indeed demonstrate a refusal to view sales of partnership interests as sales of partnership assets, but such refusal is in the context of deciding whether the gain from such sales is entitled to capital gain treatment under section 741. The courts, deciding cases of that genre on their individual facts, have variously characterized sales of partnership interests as sales of interests and sales of assets. Compare *Thornley v. Commissioner*, 147 F.2d 416 (3d Cir. 1945), and *Barran v. Commissioner*, 334 F.2d 58 (5th Cir. 1964), with *Harris v. Commissioner*, 61 T.C. 770 (1974).

In the context of deciding whether the transferee corporation took property subject to an obligation, however, different considerations apply. Section 357(c) requires only that the debt be secured by property transferred to the corporation. See *Testor v. Commissioner*, 40 T.C. 273, 275 (1963), affd. 327 F.2d 788 (7th Cir. 1964).[21] Where, as here, the partnership interests transferred are themselves encumbered in substance by a right of foreclosure on the partnership's real property, the corporation acquires such interests subject to the encumbrance. See *Commissioner v. Tufts*, 461 U.S. 300 (1983); Rev. Rul. 80–323, 1980–2 C.B. 124; see also 2 A. Willis, J. Pennell & P. Postlewaite, Partnership Taxation, sec. 101.03 (3d ed. 1982). Indeed, without such looking through the partnership interest, the impact of section 357(c) could easily be circumvented on incorporations of partnerships; only in rare instances would the partnership interest being transferred be actually encumbered by any liabilities of the transferring partner. Cf. *Alderman v. Commissioner*, *supra* at 665. Thus, the partners transferred to the corporation interests in the DC real property that were in substance subject to their shares of the $299,900 debt, and the section 357(c) liabilities include both the $185,000 and $299,900 notes.[22]

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[21] See also *Beaver v. Commissioner*, *supra*

[22] We note that there is no indication in the record herein either that the $5,995 NS & T note was assumed or that the corporation took the partnership interests subject to such note. Similarly, we have no way of knowing whether there were other liabilities (the May 11, 1978, position of the partnership shows $12,100 in miscellaneous liabilities). (See *supra* p. 895.) As the parties have not adequately addressed the issue of the disposition of such liabilities, we have concluded that they should be ignored.

Given the calculations already performed, petitioner's share of the section 357(c) liabilities may easily be computed. Originally, petitioner was allocated 100 percent of the $393,395 partnership liabilities. When Murphy bought into the partnership, petitioner's share was reduced to 92 percent. After selling one half of his interest to Mrs. Smith, petitioner's interest stood at 46 percent. When the trust purchased a 25-percent interest in the partnership from petitioner, petitioner transferred 54.3 percent of his 46-percent interest, leaving petitioner with a 21-percent share of the partnership liabilities (i.e., .457 × .46). With regard to the Wilkins note obligation, the assumption, as held above, had no effect for section 357(c) purposes on the liability as between petitioner and the partnership, i.e., the property remained subject to the mortgage. However, the assumption, also as held above, did increase the basis of the property transferred by petitioner to the corporation, i.e., his partnership interest, with the result that, as among the partners, the liability was petitioner's for purposes of section 357(c). Thus, petitioner's share of the $484,900 section 357(c) liabilities was $338,750 ($299,900 + (.21 × $185,000)). Given the $141,406 basis in petitioner's partnership interest immediately before the incorporation, petitioner's section 357(c) gain is $197,344.

In accordance with the parties' stipulations,[23] and with the foregoing opinion,

Decision will be entered under Rule 155.

APPENDIX

CALCULATION OF SMITH'S BASIS AND SHARE OF LIABILITIES

	Share of liabilities	*Basis*
Partnership debt:		
Wilkins Note	$299,900.00	$299,900.00
NS & T note	87,500.00	87,500.00
Other	5,995.00	5,995.00
	393,395.00	393,395.00

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[23] See *supra* note 2.

	Share of liabilities	*Basis*
Asset withdrawal	0	($178,485.83)
Operating loss	0	(10,865.00)
Capital contribution	0	8,000.00
		212,044.17
Admission of Murphy	($31,471.60)	(31,471.60)
	361,923.40	180,572.57
Buy-out of Bernard and Crothers	0	197,000.00
Refinancing of note		
New $185,000 note	170,200.00	170,200.00
Payoff $87,500 note	(80,500.00)	(80,500.00)
	451,623.40	467,272.57
Sale to Mrs. Smith		(197,000.00)
	(225,811.70)	(225,811.70)
	225,811.70	44,460.87
Sale to Trust		(24,142.25)
	(122,615.75)	(20,318.62)
	103,195.95	0
"Assumption of Liability"	236,921.00	236,921.00
Withdrawal of $95,515	0	(95,515.00)
Totals before incorporation	340,116.95	141,406.00

ROGER L. EWART, FIDUCIARY AND TRANSFEREE OF THE ASSETS OF THE ESTATE OF BLANCHE L. EWART, DECEASED, TRANSFEROR, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 27544–83. Filed May 20, 1985.

By order dated August 30, 1985, this opinion filed May 20, 1985, was withdrawn, and order and decision entered May 22, 1985, was vacated and set aside. Revised opinion appears at 85 T.C. ____ (October 8, 1985).

Pages 913–918 have been

deleted from this volume.

O. ROBERT FREESEN AND ALICE FREESEN, ET AL.,[1] PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 16104–83. Filed May 20, 1985.

Freesen Equipment Co., a subch. S corporation of which petitioners are the sole shareholders, entered into several joint venture agreements with Freesen, Inc., with respect to topsoil removal activities at several mine sites. Freesen Equipment Co. subsequently purchased heavy construction equipment for performance of the agreed topsoil removal activities. Under the terms of the joint venture agreements, Freesen, Inc., advanced Freesen Equipment Co. its share of the net profits in order to provide Freesen Equipment Co. the funds for payment of sec. 162, I.R.C. 1954, expenses. Petitioners, as shareholders of Frees-

[1]The following petitioners were also included in the petition: James R. Buhlig and Diane Buhlig; Kenneth T. Cox and Shirley I. Cox; Eugene J. Kroencke and Sarah R. Kroencke; Russell M. Mosley and Ruth A. Mosley; Keith B. Prunty and Norma J. Prunty; Jeffrey C. Prunty and Vickie Prunty; Kerry S. Freesen and Carol A. Freesen; Thomas L. Oetgen and Kathleen E. Oetgen; and Oscar R. Freesen and Debra Freesen.

en Equipment Co., claimed investment tax credit and accelerated depreciation deductions with respect to the heavy construction equipment. *Held*, the heavy construction equipment was subject to a lease for sec. 46(e)(3), I.R.C. 1954, purposes. *Held, further*, the transactions in issue failed to satisfy the noncorporate lessor provisions of sec. 46(e)(3), I.R.C. 1954. *Held, further*, the heavy construction equipment was subject to a lease for sec. 57(a)(3), I.R.C. 1954, purposes.

Theodore C. Rammelkamp, Jr., for the petitioners.
Michael W. Bitner, for the respondent.

GOFFE, *Judge*: The commissioner determined deficiencies in petitioners' Federal income tax as follows:

Petitioner	*Taxable year*	*Amount*
O. Robert Freesen and Alice Freesen	1978	$18,215.84
	1979	12,565.99
	1980	3,611.84
James R. Buhlig and Diane Buhlig	1978	15,795.97
	1979	9,051.76
	1980	2,627.95
Kenneth T. Cox and Shirley I. Cox	1978	16,635.44
	1979	10,500.64
	1980	333.33
Eugene J. Kroencke and Sarah R. Kroencke	1978	15,631.85
	1979	7,418.28
	1980	682.39
Russell M. Mosley and Ruth A. Mosley	1978	16,005.38
	1979	7,358.54
	1980	640.86
Keith B. Prunty and Norma J. Prunty	1978	16,401.29
	1979	10,841.06
	1980	2,628.29
Jeffrey C. Prunty	1978	18,400.24
Jeffrey C. Prunty and Vickie Prunty	1979	9,213.16
	1980	2,628.28

Petitioner	*Taxable year*	*Amount*
Kerry S. Freesen	1978	$15,720.08
Carol A. Freesen	1979	9,265.18
	1980	2,440.72
Thomas L. Oetgen	1978	16,218.11
and Kathleen E. Oetgen	1979	11,108.27
	1980	2,628.28
Oscar R. Freesen	1978	15,675.60
and Debra Freesen	1979	8,735.05
	1980	1,808.33

After concessions by the parties, the issues for decision are: (1) Whether certain heavy construction equipment purchased and owned by Freesen Equipment Co. (a subchapter S corporation of which petitioners are the sole stockholders) during the taxable years 1978, 1979, and 1980, was subject to a lease for the purposes of section 46(e)(3);[2] (2) assuming that the above question is answered in the affirmative, whether the transactions in issue satisfied the noncorporate lessor provisions of section 46(e)(3); and (3) whether the heavy construction equipment described in the first issue for decision was subject to a lease for the purposes of section 57(a)(3), so as to require that any claimed depreciation in excess of straight line be treated as a tax preference item.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and accompanying exhibits are so found and incorporated herein by reference.

All of the petitioners resided in Illinois during the taxable years in issue and when their joint petition was filed. With exception of petitioner Jeffrey C. Prunty who filed an individual Federal income tax return for the taxable year 1978, all of the petitioners filed joint Federal income tax returns with their respective spouses for the taxable years in issue. All of petitioners' Federal income tax returns for the taxable years

[2] All section and subchapter references are to the Internal Revenue Code of 1954 as amended and in effect during the taxable years in issue, and all Rule references are to this Court's Rules of Practice and Procedure.

in issue were timely filed with the Internal Revenue Service's Kansas City Service Center.

During the taxable years in issue, Freesen Equipment Co. was a corporation which was organized under the laws of the State of Nevada. During this period, Freesen Equipment Co. qualified for, and chose to be, an "electing small business corporation" under subchapter S of the Internal Revenue Code. The following petitioners owned Freesen Equipment Co. in the indicated amounts during the years before the Court:

Petitioner	*Amount*
O. Robert Freesen	10%
James R. Buhlig	10
Kenny T. Cox	10
Eugene J. Kroencke	10
Russell Mosley	10
Keith Prunty	10
Jeffrey C. Prunty	10
Kerry S. Freesen	10
Thomas L. Oetgen	10
Oscar R. Freesen III	10
Total	100

During the taxable years in issue, Freesen, Inc., was a corporation which was organized under the laws of the State of Nevada. During this period, Freesen, Inc., was, for Federal income tax purposes, operated pursuant to subchapter C of the Internal Revenue Code. During the taxable years in issue, petitioners were not the sole stockholders of Freesen, Inc. The shares of Freesen, Inc., were held as follows at the dates indicated:

	SHARES		
Shareholders	*May 1, 1978*	*June 1, 1979*	*Oct. 1, 1980*
O. Robert Freesen	1,856	9,784	9,840
Keith B. Prunty	211	1,055	0
Kenneth T. Cox	220	1,100	0
L. Leroy Freesen	112	56	0
William F. Nunes	72	360	435
Gerald E. Day	45	225	265
Vivian H. Bentley, Jr.	44	220	220
Thomas L. Oetgen	37	185	375
J. Craig Prunty	36	180	245
Eugene J. Kroencke	30	150	175
O.R. Freesen III	28	140	157
James R. Buhlig	23	115	280

	SHARES		
Shareholders	*May 1, 1978*	*June 1, 1979*	*Oct. 1, 1980*
Robert J. Henkhaus	20	100	100
Kerry S. Freesen	18	90	130
Glen C. Clevenger	13	65	77
Matthew Freesen	13	65	65
Guy Freesen	13	65	65
James A. McLaughlin	13	65	85
Russell M. Mosley	10	50	107
Samuel R. Killebrew	8	40	90
Barry E. Bringman	5	25	45
Max L. Edlen	5	25	36
Joseph Brown	4	20	0
James W. Claussen	4	20	55
Edgar A. Bobb	0	0	31
John Steinberg	0	0	10
Don E. Davis	0	0	10
Lowell Yocom	0	0	10
Stephen J. Cobb	0	0	6
James C. Littig	0	0	5
Willard Tranbarger	0	0	2
Treasury	0	0	1,279
Total	2,840	14,200	14,200

During the taxable years in issue, Freesen, Inc., was a construction contractor whose business consisted primarily of road contracting with a strong secondary interest in land clearing operations. In the course of its business, Freesen, Inc., entered into the following agreements entitled "Contract for Topsoil Removal" with Peabody Coal Co. (hereinafter referred to as Peabody):

Date of agreement	*Term*	*Location*
Jan. 11, 1978	Mar. 1, 1978—Feb. 28, 1979	Power Mine
Apr. 13, 1979	May 1, 1979—Apr. 30, 1980	Power Mine
Apr. 9, 1980	May 1, 1980—Apr. 30, 1981	Power Mine
Jan. 11, 1978	Mar. 1, 1978—Feb. 28, 1979	Tebo Mine
Apr. 13, 1979	May 1, 1979—Apr. 30, 1980	Tebo Mine

Pursuant to these agreements, Freesen, Inc., contracted to excavate, remove, and replace (after mining and grading by Peabody), and stockpile as required, all of the topsoil material at the indicated mine sites which were located in Henry and Johnson counties in the State of Missouri. These contracts for topsoil removal were entered into by Peabody with Freesen, Inc., in order that Peabody might have the benefit of Freesen,

Inc.'s management and expertise in topsoil removal. Such management and expertise were, in fact, provided during the performance of these agreements.

Pursuant to paragraph 1 of all of the above-described contracts for topsoil removal, Freesen, Inc., was obligated to provide all of the equipment, supervisory labor, and maintenance labor necessary for the topsoil removal at the two mine sites. Pursuant to paragraph 2(b) of these agreements, either party had the right to terminate such contracts for its own convenience by delivering written notice thereof to the other party. Further, pursuant to paragraph 3 of these agreements, subject to monthly standby provisions whereby Freesen, Inc., was to be compensated for making specified equipment available, Peabody was obligated to pay hourly or monthly rates for the usage of the equipment provided by Freesen, Inc., which equipment was to be operated by Peabody's employees.

Freesen, Inc., did not own all of the equipment necessary for the performance of the above-described contracts for topsoil removal. Road contracting, such as Freesen, Inc., performs in the normal course of its business, requires significant amounts of unimpaired equity capital in order to satisfy requirements imposed by State governments and commercial bonding companies. Had Freesen, Inc., purchased the equipment called for by the contracts for topsoil removal, its capital would have been severely impaired, hindering its ability to pursue its major line of business, road contracting. Therefore, in 1978, petitioners formed Freesen Equipment Co. in order to provide the necessary equipment and capital to perform the above-described contracts for topsoil removal without impairing the capital of Freesen, Inc. For its initial capitalization, each shareholder contributed $10,000 cash to Freesen Equipment Co.

On March 23, 1978, Freesen, Inc., and Freesen Equipment Co. entered into a "Joint Venture Agreement," the pertinent portions of which provided as follows:

JOINT VENTURE AGREEMENT

On this 23 day of March, 1978, FREESEN INC., a Nevada Corporation, hereinafter referred to as "Inc.", and FREESEN EQUIPMENT CO., a Nevada Corporation, hereinafter referred to as "Equipment Co.", agree to engage in and carry on as joint venturers (for profit) to complete the contracts dated January 11, 1978 between FREESEN INC. and PEABODY

COAL COMPANY, for topsoil removal at Peabody's Power Mine located in Henry County, Missouri, and Peabody's Tebo Mine located in Henry and Johnson Counties, Missouri, and hereinafter referred to as the "Peabody Contract". Such enterprise will have its main office at Bluffs, Illinois.

In consideration of the mutual promises made herein, the parties agree as follows:

I. *Contributions*

A. Inc. shall contribute the equipment and services more particularly described in Exhibit A attached hereto and made a part hereof.

B. Equipment Co. shall contribute the equipment and services more particularly described in Exhibit B attached hereto and made a part hereof.

C. The parties shall make their contribution at the time performance under the Peabody contract described above shall commence.

D. If either party fails to make its contribution within thirty (30) days of notice of failure to do so, then the other party can declare the joint venture null and void and secure its share of the profits.

II. *Rights, Powers and Duties*

A. Equipment Co. shall assume the duties shown in Exhibit B to this agreement and Inc. shall assume the duties shown in Exhibit A.

B. The parties designate Inc. as the sponsoring joint venturer. The Peabody contract shall be carried out and performed on behalf of the joint venture under the direction of the sponsoring joint venturer, acting through such of its officers, employees or agents as it may hereafter at any time or from time to time designate.

III. *Division of Profits/Loss*

A. Inc. shall collect, receive and deposit all sums due, earned and paid under the Peabody contract.

B. Equipment Co. shall bill Inc. monthly for advances on equipment usage and the actual costs for service personnel, insurance, taxes, fuel and lubricants, and parts replaced or repaired on vehicles repaired or replaced under the services and maintenance provisions of this agreement. Inc. shall pay Equipment Co. for such billings on a monthly basis.

C. At the end of the calendar year of each year this joint venture is in force and upon completion of the Peabody contract, the parties shall make a general accounting of net profits and loss after allocation of costs of the joint venture. The first $1,100,000.00 of net profit shall be paid to Equipment Co. The next $2,200,000.00 of net profit shall be paid to Inc. Any net profit over $3,300,000.00 shall be divided equally between the parties.

D. Losses shall be shared on the same proportional basis as profits are to be distributed.

IV. *Bank Accounts*

All funds advanced by the parties to this agreement and all progress and final payments or other revenue received as the result of the performance of the Peabody contract may be deposited to the account of the joint venture established at such bank or banks as the sponsoring joint venturer may designate. All joint venturers will be advised by the sponsoring joint venturer as to any bank accounts established.

Checks may be drawn on such account or accounts by signature or signatures of such persons as may be designated by the sponsoring venturer

from time to time. Unless and until otherwise agreed, the sponsoring venturer is authorized to designate the persons to be authorized to draw checks on the bank account or accounts.

The joint venture may also maintain payroll or other accounts at such bank or at such branch or at such other bank as the sponsoring joint venturer may designate. Checks may be drawn on such accounts by signature or signatures of such persons as may be designated by the sponsoring joint venturer. Without limiting the right of the sponsoring joint venturer to change the persons authorized to sign on the various bank accounts that may be established as provided herein, any one of the following persons is authorized to sign checks drawn on the designated accounts:

Thomas Oetgen, Keith Prunty, Craig Prunty, and Jim Buhlig

V. *Books of Accounts; Audits*

A. Adequate books of account shall be maintained by each joint venturer. Such books of account may be examined by any of the joint venturers at any reasonable time.

B. A periodic audit of such books may be made by an independent firm of certified public accountants as agreed by the parties. Copies of such audit reports shall be delivered to each joint venturer.

VI. *Limitation of Joint Venture*

It is specifically understood and agreed between the parties that this joint venture agreement extends only for the performance of the Peabody contract, together with any changes or additions thereto or extra work thereunder; in no event shall this agreement extend to or cover any or different work. Nor does this agreement create any permanent partnership agreement or joint venture agreement to bid or undertake any additional work. Nothing in this agreement shall be construed as a limitation of the powers or rights of any party to carry on its separate business for its sole benefit except, however, that the parties shall cooperate with one another according to the terms and spirit of this agreement in the performance of the Peabody contract.

* * * * * * *

EXHIBIT A TO JOINT VENTURE AGREEMENT BETWEEN FREESEN INC. and FREESEN EQUIPMENT CO.

FREESEN INC. shall contribute and perform the following in completion of the Peabody contract and this Joint Venture Agreement:

1. All supervision and direction of the work and operations described in the Peabody contract including, but not limited to, all necessary supervisory personnel and support facilities not otherwise provided by FREESEN EQUIPMENT CO.;

2. Certain equipment and trucks including, but not limited to:

a. Pickup trucks for Freesen Inc. supervisory personnel

* * * * * * *

3. Any additional labor, materials, equipment necessary to perform any work unrelated to topsoil removal as required by paragraph 1(b) of the Peabody contract. Such contribution may be made after the commencement of work on the contract and failure to make such contribution with other contributions shall not be a cause for failure of Inc. to perform the Joint Venture Agreement.

EXHIBIT B TO JOINT VENTURE AGREEMENT BETWEEN FREESEN INC. and FREESEN EQUIPMENT CO.

FREESEN EQUIPMENT CO. shall contribute and perform the following in completion of the Peabody contract and this Joint Venture Agreement:

1. Furnish and deliver to the mine site the following equipment and vehicles necessary to assist in the removal of topsoil as required by the Peabody contract:

a. 10 Caterpillar 631D Tractor-Scraper Units
b. 3 Caterpillar D-9H Crawler Tractor Units
c. 3 Caterpillar D-8K Crawler Tractor Units
d. 2 Caterpillar 16G Motorgraders
e. 2 Caterpillar 621B Tractor with Klein KT-7000 Water Wagons
f. Trucks

2. Service and maintain all equipment and vehicles delivered to the mine site by Equipment Co. and by Inc. Service and maintenance shall include but not be limited to: (a) changing and checking gas, diesel, fuel, oil, lubrication and filters; (b) inspecting, repairing, replacing worn, defective and damaged parts to engines, transmissions, hydraulic controls and systems, brakes, drive trains, steering, final drive, steering clutches, undercarriage and to any other part of the equipment and vehicles which fail to function properly; (c) furnishing sufficient supervisory personnel and other labor, if required, to carry out and supervise all such changing, checking, inspecting, replacing and completing work necessary to service and maintain the equipment and vehicles delivered under this agreement in an operable condition.

3. Remove and pick up any equipment and vehicles which need to be removed from the mine site during the course of this agreement, whether on a temporary or permanent basis and regardless of whether Inc. or Equipment Co. delivered the equipment and vehicles to the mine site.

4. Purchase fuel for the equipment and vehicles delivered to the mine site by Inc. or Equipment Co., deliver such fuel to the mine site and cause the equipment and vehicles of Inc. and Equipment Co. at the mine site to be fueled every day said equipment and vehicles are used in performing the Peabody contract.

5. Provide security and protective services to guard the equipment and vehicles of Equipment Co. and Inc. at the mine site on off hours, weekends and holidays against theft, vandalism, and other related crimes.

6. Procure and maintain in force insurance on the equipment and vehicles furnished and delivered by Equipment Co. to the mine site. The insurance shall provide coverage for personal injury and death, property damage and extended coverage with reasonable limits of coverage.

7. Administer, investigate and process any and all claims for loss, property damage, personal injury or death arising out of the operations of Inc. or Equipment Co. in the performance of the Peabody contract and this joint venture. Equipment Co. by performing these services shall not assume the duties of or in any way prejudice the rights of any insurance carrier of Inc., Equipment Co. or Peabody Coal Company.

8. Establish and maintain adequate service-logs on each item of equipment delivered and used at the mine site for performance of the Peabody contract. These records shall be kept on a daily basis by personnel of Freesen Equipment Co. and shall contain the hours each is used, dates of oil and filter changes, oil sample analyses, systems inspection reports, hour meter readings, and mechanics repair summaries.

On April 23, 1979, Freesen, Inc., and Freesen Equipment Co. entered into a "Continuation of Joint Venture Agreement," the pertinent portions of which provided as follows:

CONTINUATION OF JOINT VENTURE AGREEMENT

WHEREAS, on the 23rd day of March, 1978, FREESEN INC., a Nevada Corporation, and FREESEN EQUIPMENT CO., a Nevada Corporation, did enter into an agreement to engage in and carry on as joint venturers (for profit) to complete certain contracts dated January 11, 1978, between FREESEN INC. and PEABODY COAL COMPANY for topsoil removal at Peabody's Power Mine and Tebo Mine, said contracts being for a term of one year commencing May 1, 1978, and

WHEREAS, on the 13th day of April, 1979, FREESEN INC. did enter into renewal of said contracts with PEABODY COAL COMPANY for topsoil removal at Peabody's Power Mine and Tebo Mine, said renewal contracts being for a term of one year, commencing May 1, 1979, and

WHEREAS, FREESEN INC. and FREESEN EQUIPMENT CO. desire to continue as joint venturers (for profit) to complete the contracts dated April 13, 1979, between FREESEN INC. and PEABODY COAL COMPANY for topsoil removal at Peabody's Power Mine and Tebo Mine,

NOW, THEREFORE, BE IT RESOLVED by and between FREESEN INC. and FREESEN EQUIPMENT CO., the Parties hereto, that all terms and conditions of the joint venture agreement entered into by and between said Parties on the 23rd day of March, 1978, shall remain in full force and effect until the contracts between FREESEN INC. and PEABODY COAL COMPANY dated April 13, 1979, have been completed.

On April 28, 1980, Freesen, Inc., and Freesen Equipment Co. entered into a "Joint Venture Agreement," the pertinent portions of which provided as follows:

JOINT VENTURE AGREEMENT

On this 28 day of April, 1980 FREESEN INC., a Nevada Corporation, hereinafter referred to as "Inc.", and FREESEN EQUIPMENT CO., a Nevada Corporation, hereinafter referred to as "Equipment Co.", agree to engage in and carry on as joint venturers (for profit) to complete the contracts dated April 9, 1980, between FREESEN INC. and PEABODY COAL CO., for topsoil removal at Peabody's Power Mine located in Henry County, Missouri,

.....and hereinafter referred to as the "Peabody Contract". Such enterprise will have its main office at Bluffs, Illinois.

In consideration of the mutual promises made herein, the parties agree as follows:

I. *Contributions*

A. Inc. shall contribute the equipment and services more particularly described in Exhibit A attached hereto and made a part hereof.

B. Equipment Co. shall contribute the equipment and services more particularly described in Exhibit B attached hereto and made a part hereof.

C. The parties shall make their contribution at the time performance under the Peabody contract described above shall commence.

D. If either party fails to make its contribution within thirty (30) days of notice of failure to do so, then the other party can declare the joint venture null and void and secure its share of the profits.

II. *Rights, Powers and Duties*

A. Equipment Co. shall assume the duties shown in Exhibit B to this agreement and Inc. shall assume the duties shown in Exhibit A.

B. The parties designate Inc. as the sponsoring joint venturer. The Peabody contract shall be carried out and performed on behalf of the joint venture under the direction of the sponsoring joint venturer, acting through such of its officers, employees or agents as it may hereafter at any time or from time to time designate.

III. *Division of Profits/Loss*

A. Inc. shall collect, receive and deposit all sums due, earned and paid under the Peabody contract.

B. Equipment Co. shall bill Inc. monthly for advances on equipment useage [sic] and the actual costs for service personnel, insurance, taxes, fuel and lubricants, and parts replaced or repaired on vehicles repaired or replaced under the services and maintenance provision of this agreement. Inc. shall pay Equipment Co. for such billings on a monthly basis.

C. At the end of the calendar year of each year this joint venture is in force and upon completion of the Peabody contract, the parties shall make a general accounting of net profits and loss after allocation of costs of the joint venture. The first $900,000.00 of net profit shall be paid to Equipment Co. The next $2,200,000.00 of net profit shall be paid to Inc. Any net profit over $3,100,000.00 shall be divided equally between the parties.

D. Losses shall be shared on the same proportional basis as profits are to be distributed.

IV. *Bank Accounts*

All funds advanced by the parties to this agreement and all progress and final payments or other revenue received as the result of the performance of the Peabody contract may be deposited to the account of the joint venture established at such bank or banks as the sponsoring joint venturer may designate. All joint venturers will be advised by the sponsoring joint venturer as to any bank accounts established.

Checks may be drawn on such account or accounts by signature or signatures of such persons as may be designated by the sponsoring venturer from time to time. Unless and until otherwise agreed, the sponsoring venturer is authorized to designate the persons to be authorized to draw checks on the bank account or accounts.

The joint venture may also maintain payroll or other accounts at such bank or at such branch or at such other bank as the sponsoring joint venturer may designate. Checks may be drawn on such accounts by signature or signatures of such persons as may be designated by the sponsoring joint venturer. Without limiting the right of the sponsoring joint venturer to change the persons authorized to sign on the various bank accounts that may be established as provided herein, any of the following persons is authorized to sign checks drawn on the designated accounts:

Any Corporation officer of the sponsoring joint venturer

V. *Books of Accounts; Audits*

A. Adequate books of account shall be maintained by each joint venturer. Such books of account may be examined by any of the joint venturers at any reasonable time.

B. A periodic audit of such books may be made by an independent firm of certified public accountants as agreed by the parties. Copies of such audit reports shall be delivered to each joint venturer.

* * * * * * *

EXHIBIT A TO JOINT VENTURE AGREEMENT BETWEEN FREESEN INC. and FREESEN EQUIPMENT CO.

FREESEN INC. shall contribute and perform the following in completion of the Peabody contract and this Joint Venture Agreement:

1. All supervision and direction of the work and operations described in the Peabody contract including, but not limited to, all necessary supervisory personnel and support facilities not otherwise provided by FREESEN EQUIPMENT CO.;

2. Certain equipment and trucks including, but not limited to:

a. Pickup trucks for Freesen Inc. supervisory personnel

* * * * * * *

3. Any additional labor, materials, equipment necessary to perform any work unrelated to topsoil removal as required by paragraph 1(b) of the Peabody contract. Such contribution may be made after the commencement of work on the contract and failure to make such contribution with other

contributions shall not be a cause for failure of Inc. to perform the Joint Venture Agreement.

EXHIBIT B TO JOINT VENTURE AGREEMENT BETWEEN FREESEN INC. and FREESEN EQUIPMENT CO.

FREESEN EQUIPMENT CO. shall contribute and perform the following in completion of the Peabody contract and this Joint Venture Agreement:

1. Furnish and deliver to the mine site the following equipment and vehicles necessary to assist in the removal of topsoil as required by the Peabody contract:

(10) Caterpillar 631D Tractor-Scraper Units
(3) Caterpillar D-9H Crawler Tractor/Dozer Units
(4) Caterpillar D-8K Crawler Tractor/Dozer Units
(2) Caterpillar 16G Motor Graders
(1) Caterpillar 920 Wheel Tractor Loader
(2) Caterpillar 621B Tractors w/Klein KT7000 Water Wagons
(1) Caterpillar DW21 Tractor w/8000 gallon water wagon
Trucks—Mechanic, Service and Grease
Mobile Office

2. Service and maintain all equipment and vehicles delivered to the mine site by Equipment Co. and by Inc. Service and maintenance shall include but not be limited to: (a) changing and checking gas, diesel, fuel, oil, lubrication and filters; (b) inspecting, repairing, replacing worn, defective and damaged parts to engines, transmissions, hydraulic controls and systems, brakes, drive trains, steering, final drive, steering clutches, undercarriage and to any other part of the equipment and vehicles which fail to function properly; (c) furnishing sufficient supervisory personnel and other labor, if required, to carry out and supervise all such changing, checking, inspecting, replacing and completing work necessary to service and maintain the equipment and vehicles delivered under this agreement in an operable condition.

3. Remove and pick up any equipment and vehicles which need to be removed from the mine site during the course of this agreement, whether on a temporary or permanent basis and regardless of whether Inc. or Equipment Co. delivered the equipment and vehicles to the mine site.

4. Purchase fuel for the equipment and vehicles delivered to the mine site by Inc. or Equipment Co., deliver such fuel to the mine site and cause the equipment and vehicles of Inc. and Equipment Co. at the mine site to be fueled every day said equipment and vehicles are used in performing the Peabody contract.

5. Provide security and protective services to guard the equipment and vehicles of Equipment Co. and Inc. at the mine site on off hours, weekends and holidays against theft, vandalism, and other related crimes.

6. Procure and maintain in force insurance on the equipment and vehicles furnished and delivered by Equipment Co. to the mine site. The insurance shall provide coverage for personal injury and death, property damage and extended coverage with reasonable limits of coverage.

7. Administer, investigate and process any and all claims for loss, property damage, personal injury or death arising out of the operations of Inc. or Equipment Co. in the performance of the Peabody contract and this joint venture. Equipment Co. by performing these services shall not assume the duties of or in any way prejudice the rights of any insurance carrier of Inc., Equipment Co. or Peabody Coal Company.

8. Establish and maintain adequate service-logs on each item of equipment delivered and used at the mine site for performance of the Peabody contract. These records shall be kept on a daily basis by personnel of Freesen Equipment Co. and shall contain the hours each is used, dates of oil and filter changes, oil sample analyses, systems inspection reports, hour meter readings, and mechanics repair summaries.

Pursuant to its obligations under the joint venture agreements,[3] Freesen Equipment Co. purchased the equipment required thereby on the dates and at the prices, with such equipment having the useful lives as shown on page 935.

In a letter dated December 17, 1979, Peabody exercised its termination option with respect to the contract for topsoil removal for the Tebo Mine dated April 13, 1979. The termination took effect on February 15, 1980. Otherwise, the parties performed all of the terms of the contracts for topsoil removal in the manner required by the contracts.

The equipment purchased by Freesen Equipment Co. pursuant to its obligations to Freesen, Inc., under the joint venture agreements was placed into service by Freesen Equipment Co. during the taxable years in which such equipment was purchased.

On their Federal income tax returns for the taxable years in issue, petitioners (as shareholders of Freesen Equipment Co., a subchapter S corporation) claimed accelerated depreciation deductions with respect to the equipment purchased by Freesen Equipment Co. Petitioners also claimed investment tax credit concerning this equipment as follows:

	Taxable year		
Petitioner	*1978*	*1979*	*1980*
O. Robert Freesen and Alice Freesen	$12,692.50	$826.22	$333.33
James R. Buhlig and Diane Buhlig	12,692.50	826.22	333.00

[3]For discussion purposes hereafter, all references to the joint venture agreements include all joint venture agreements and the continuation venture agreement.

	Taxable year		
Petitioner	*1978*	*1979*	*1980*
Kenneth T. Cox and Shirley I. Cox	$12,693.50	$826.00	$333.33
Eugene J. Kroencke and Sarah R. Kroencke	12,700.00	826.00	333.33
Russell M. Mosley and Ruth A. Mosley	12,692.51	826.22	333.00
Keith B. Prunty and Norma J. Prunty	12,692.50	826.00	333.33
Jeffrey C. Prunty	12,692.50	0	0
Jeffrey C. Prunty and Vickie Prunty	0	826.22	333.33
Kerry S. Freesen and Carol A. Freesen	12,692.50	826.22	333.00
Thomas L. Oetgen and Kathleen E. Oetgen	12,692.51	826.22	333.33
Oscar R. Freesen and Debra Freesen	12,692.50	826.22	333.00

In the notices of deficiency mailed to petitioners, the Commissioner determined that the equipment purchased by Freesen Equipment Co. did not qualify as section 38 property.[4] The Commissioner also determined that the property in question was subject to a lease and that it had not been shown that the noncorporate lessor provisions of section 46(e)(3) had been met with respect to such property.[5] Finally, the Commissioner determined that a portion of the accelerated depreciation deductions claimed by Freesen Equipment Co. on its 1978, 1979, and 1980 Federal income tax returns constituted items of tax preference to petitioners as the stockholders of Freesen Equipment Co. pursuant to section 57 and accompanying regulations because: (1) The property was subject to a lease for purposes of section 57(a)(3) and (2) it had not been shown that the accelerated depreciation deductions claimed by Freesen Equipment Co. with respect to the property were less than the allowable deductions had the straight line method of depreciation been utilized.[6]

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[4] Respondent now acknowledges that this equipment is sec. 38 property.

[5] Respondent also acknowledges that if the Court holds that the equipment in issue purchased by Freesen Equipment Co. was not subject to a lease, petitioners are entitled to the investment tax credit claimed on their returns in issue and it will not be necessary for the Court to determine whether the noncorporate lessor provisions of sec. 46(e)(3) have been satisfied.

[6] Respondent acknowledges that if the Court decides that the property in issue purchased by Freesen Equipment Co. is not subject to a lease for the purposes of sec. 57(a)(3), then the

Date	*Quantity*	*Description*	*Useful life*	*Cost*
March 1978	10	Caterpillar 631 D tractor scraper units (new)	10,000 hours (5 years)	$2,075,459
March 1978	3	Caterpillar D-911 tractors (new)	10,000 hours (5 years)	597,801
March 1978	3	Caterpillar D-8K crawler tractors	10,000 hours (5 years)	426,584
March 1978	2	Caterpillar 16 G motor graders (new)	10,000 hours (5 years)	258,372
March 1978	2	Caterpillar 621 B tractors	10,000 hours (5 years)	279,079
March, April 1978	- - -	Miscellaneous trucks buses and trailers (new and used)	4 years	136,744
May 1978	1	8000 gallon G.M. water truck (new)	5 years	33,713
April 1979	1	Caterpillar 920 wheel tractor loader (new)	5 years	47,000
April 1979	1	Caterpillar D-8K crawler tractor (new)	10,000 hours (5 years)	153,067
August 1980	2	Caterpillar 631 C tractors (used)	10,000 hours (5 years)	348,000

OPINION

The first issue for decision is whether certain heavy construction equipment purchased and owned by Freesen Equipment Co. during the years 1978, 1979, and 1980 was subject to a lease for the purposes of section 46(e)(3). In the notices of deficiency mailed to the petitioners, the Commissioner determined that such heavy construction equipment was subject to a lease. The Commissioner's determination is presumptively correct (*Welch v. Helvering*, 290 U.S. 111, 115 (1933)), and petitioners bear the burden of proving it to be erroneous. Rule 142(a).

Petitioners maintain that the joint venture agreements between Freesen, Inc., and Freesen Equipment Co. are not leases under both the control and risk of loss tests of *Meagher v. Commissioner*, T.C. Memo. 1977-270. Petitioners also assert that it is unfair to characterize the joint venture agreements as leases, where the transaction was structured at arm's length for valid business reasons. In support thereof, they claim that the Commissioner's determination that the joint venture agreements are leases for section 46(e)(3) purposes is inconsistent with respondent's stipulation that Freesen Equipment Co. qualified as and chose to be "an electing small business corporation" under subchapter S in that the joint venture agreements did not produce rents so as to disqualify its subchapter S election.

Respondent contends that the joint venture agreements between Freesen, Inc., and Freesen Equipment Co. are leases for section 46(e)(3) purposes. In support thereof, respondent asserts that a review of the parties' contributions and responsibilities under the joint venture agreements in light of applicable case law and regulations warrants a conclusion that these operating documents were, in reality, leases. Respondent disputes petitioners' claim that, pursuant to the joint venture agreements, Freesen Equipment Co. exercised sufficient control over the topsoil removal activities and retained a sufficient risk of loss so as to preclude a lease characterization for

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accelerated depreciation deductions will not constitute items of tax preference to petitioners. Further, petitioners acknowledge that if the Court determines that such property is subject to a lease, then the Commissioner's determination that such accelerated depreciation deductions constitute items of tax preference is correct.

section 46(e)(3) purposes. Respondent also claims that the definition of a lease set forth in section 1.57–3(d)(1), Proposed Income Tax Regs., is controlling as this proposed provision was promulgated with explicit congressional authority under section 38(b) and is a reasonable and consistent interpretation of the statute. Finally, respondent rejects petitioners' claim that the stipulation that Freesen Equipment Co. was a valid subchapter S corporation during the years in issue is inconsistent with the Commissioner's determination that the joint venture agreements are leases for section 46(e)(3) purposes.

Section 46(e)(3)[7] contains several qualification requirements concerning a noncorporate lessor's entitlement to investment tax credit with respect to the leased property. No statutory provisions, however, define the term "lease" for the purposes of this section.

Respondent devotes considerable attention on brief to his position that the definition of "lease" as contained in section 1.57–3(d)(1), Proposed Income Tax Regs., is controlling and precludes any nonleasing characterization. As we recently observed in *Amerco v. Commissioner*, 82 T.C. 654, 682 (1984), this proposed regulation defines the term "lease" in an extremely broad manner, i.e., "any arrangement or agreement, formal or informal, written or oral, by which the owner of property (the 'lessor') receives consideration in any form for the use of his property by another party." Although this definition of a lease has remained in the proposed stage for over 14 years[8] respondent nevertheless contends that it has

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[7] Sec. 46(e)(3) provides in relevant part that:

SEC. 46(e). LIMITATIONS WITH RESPECT TO CERTAIN PERSONS.—

(3) NONCORPORATE LESSORS.—A credit shall be allowed by section 38 to a person which is not a corporation with respect to property of which such person is the lessor only if—

(A) the property subject to the lease has been manufactured or produced by the lessor, or

(B) the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property, and for the period consisting of the first 12 months after the date on which the property is transferred to the lessee the sum of the deductions with respect to such property which are allowable to the lessor solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) exceeds 15 percent of the rental income produced by such property.

In the case of property of which a partnership is the lessor, the credit otherwise allowable under section 38 with respect to such property to any partner which is a corporation shall be allowed notwithstanding the first sentence of this paragraph. For purposes of this paragraph, an electing small business corporation (as defined in section 1371) shall be treated as a person which is not a corporation.

[8] This proposed regulation first appeared in the Federal Register on Dec. 30, 1970. 35 Fed. Reg. 19769 (1970).

the effect of law. In support thereof, respondent observes that section 1.46–4(d)(4), Income Tax Regs., provides that "For purposes of determining under this paragraph [I.R.C. section 46(e)(3)] whether property is subject to a lease, the provisions of section 1.57–3(d)(1) [Proposed Income Tax Regs.] (relating to definition of a lease) shall apply." Citing *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), and other cases, respondent then asserts "that the regulation here in question is a reasonable and consistent interpretation of the statute, and must, therefore, be upheld."

Respondent also asserts that, because the regulations under section 46(e)(3) were promulgated with explicit congressional authority pursuant to section 38(b), the "customary deference" of the courts to respondent's regulations "is particularly appropriate." *Commissioner v. Portland Cement Co. of Utah*, 450 U.S. 156, 169 (1981). Respondent adds that "it is of no consequence that [section 1.46–4(d)(4), Income Tax Regs.] does not itself contain a definition of a 'lease,' but instead incorporates by reference the definition contained in Proposed Treas. Reg. section 1.57–3(d)(1)."

Finally, after concluding that the legislative history accompanying the enactment of section 46(e)(3) warrants a finding that the proposed definition is valid, respondent contends that the lack of substantive changes made by Congress to section 46(e)(3), subsequent to its enactment, indicates that Congress "has tacitly approved" section 1.46–4(d)(4), Income Tax Regs., and its cross-reference to the definition of the term "lease" in section 1.57–3(d)(1), Proposed Income Tax Regs. In support of this claim, respondent observes that, since the adoption of section 1.46–4(d)(4), Income Tax Regs.,[9] section 46(e)(3) has been amended twice.[10] In neither of these amendments, however, did Congress either make substantive changes in the statute or criticize in the legislative history respondent's definition of a lease for the purposes of section 46(e)(3). Accordingly, respondent argues that the proposed definition contained in section 1.57–3(d)(1), Proposed Income Tax Regs., is controlling because the Supreme Court declared in *Helvering v. Winmill*, 305 U.S. 79, 83 (1938), that:

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[9] Sec. 1.46–4(d)(4), Income Tax Regs., was adopted on Aug. 25, 1972. T.D. 7203, 1972–2 C.B. 12.

[10] See Technical Corrections Act of 1979, Pub. L. 96–222, 94 Stat. 194, and Economic Recovery Tax Act of 1981, Pub. L. 97–34, 95 Stat. 172, 228.

Treasury regulations * * * long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law. [Fn. ref. omitted.]

While respondent has advanced several arguments as to why the definition of "lease" contained in section 1.57–3(d)(1), Proposed Income Tax Regs., is controlling, neither party addressed the critical concern, i.e., the effect given proposed regulations. As we have previously held, proposed regulations "carry no more weight than a position advanced on brief by the respondent." *F.W. Woolworth Co. v. Commissioner*, 54 T.C. 1233, 1265–1266 (1970). See also *Scott v. Commissioner*, 84 T.C. 683 (1985). Therefore, while the applicable legislative history may confirm the language contained in section 1.46–4(d)(4), Income Tax Regs., and such language may receive additional support due to its longevity and deference to its promulgator, none of respondent's arguments can alter the indisputable fact that section 1.46–4(d)(4), Income Tax Regs., merely cross-references section 1.57–3(d)(1), Proposed Income Tax Regs., for the definition of "lease." As the definition of "lease" contained in section 1.57–3(d)(1), Proposed Income Tax Regs., has remained in the proposed stage for over 14 years, it also "carr[ies] no more weight than a position advanced on brief by the respondent." *F.W. Woolworth Co. v. Commissioner*, *supra*. Therefore, the definition of lease contained in section 1.57–3(d)(1), Proposed Income Tax Regs., does not have the effect of law as respondent contends.

As for what constitutes a lease for section 46(e)(3) purposes, we agree with respondent that Congress has delegated this responsibility to the Secretary of the Treasury or his delegate. Secs. 38(b) and 7701(a)(11)(B). For reasons unbeknown to us, however, more than 14 years have elapsed and the definition still remains in the proposed stage. Under these circumstances, we decline to usurp the delegation of responsibility bestowed upon the Secretary or his delegate by defining this term for them.

Petitioners contend that the agreements in issue are joint venture agreements and not leases. Petitioners, however, concentrate the bulk of their efforts on showing that these agreements are not leases, and devote less time to showing that they are joint venture agreements. Relying heavily on

Meagher v. Commissioner, T.C. Memo. 1977–270, petitioners maintain that the agreements between Freesen, Inc., and Freesen Equipment Co. are not leases under both the control and risk of loss tests contained therein. Although *Meagher* concerned whether an agreement constituted a lease or management contract, petitioners assert that *Meagher* is relevant in that it "tells us what a lease is not." In this regard, petitioners claim that Freesen Equipment Co. "exercised *Meagher* type control over the Joint Venture." Further, petitioners contend that Freesen Equipment Co. "exercised significant non-*Meagher* type control of the joint venture by maintaining possession of its equipment and serving an active, daily, ongoing role in the Joint Venture." Petitioners also claim that Freesen Equipment Co. bore a real risk of economic loss under the joint venture agreements as its compensation was strictly contingent on, and proportional to, economic success, and it was liable for joint venture losses in the same proportion as profits.

In *Amerco v. Commissioner*, 82 T.C. 654, 670 (1984), which dealt with whether an agreement constituted a lease or management contract for investment tax credit purposes,[11] and other cases,[12] this Court recognized that two key factors indicate the existence of a management contract: (1) Control over the venture by the property owner, and (2) risk of loss on the property owner. *State National Bank of El Paso v. United States*, 509 F.2d 832 (5th Cir. 1975); *Kingsbury v. Commissioner*, 65 T.C. 1068 (1976). In the absence of such factors, we have characterized the agreements as leases. *Amerco v. Commissioner, supra*.[13] In making this determination, the substance of the underlying transaction, and not the form of the contract, itself, controls its interpretation for tax purposes. We must consider all of the facts and surrounding circumstances in order to determine the intent of the parties as revealed in their actions and statements and the overall economic realities of the transaction. *Amerco v. Commissioner, supra* at 670; *Kingsbury v. Commissioner, supra* at 1085.

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[11] In *Amerco v. Commissioner*, 82 T.C. 654, 669 n. 9 (1984), the Court did not consider the issue present in the immediate case, i.e., whether the agreements in issue constituted a joint venture or lease.

[12] The cases include *Meagher v. Commissioner*, T.C. Memo. 1977–270.

[13] See also *Meagher v. Commissioner, supra*.

With respect to the control test, Freesen Equipment Co. did not possess the requisite control over the activities necessary for the performance of the contracts for topsoil removal with Peabody. Rule 142(a). While Freesen Equipment Co. did exercise some minor supervisory functions concerning the maintenance and servicing of its equipment according to the terms of the joint venture agreements, these supervisory activities were limited to its own equipment and hardly amount to the requisite control over the entire *venture*. *Amerco v. Commissioner*, *supra*; *State National Bank of El Paso v. United States*, *supra*; *Kingsbury v. Commissioner*, *supra*. Instead, control over the venture (the performance of the contracts for topsoil removal) rested solely upon Freesen, Inc.'s shoulders according to the joint venture agreements. Freesen, Inc., was designated as the "sponsoring joint venturer" and the Peabody contract was to "be carried out and performed * * * under the direction of the sponsoring joint venturer." Further, Freesen Equipment Co. was not even a party to the Peabody contracts for topsoil removal as these agreements were between Freesen, Inc., and Peabody.

Additional evidence of Freesen Equipment Co.'s lack of control over the venture as a whole (as compared to exercising some minor supervisory and maintenance responsibilities with respect to its equipment) concerns its lack of control over the funds associated with the performance of the Peabody contract. Peabody paid Freesen, Inc., who as the "sponsoring joint venturer," unilaterally designated who was authorized to draw on the accounts into which the Peabody payments were placed.[14] Moreover, the joint venture agreements lack "best efforts" clauses obligating Freesen, Inc., to obtain the maximum hourly usage rate of the equipment in the performance of the contracts for topsoil removal. The lack of such a provision has been interpreted to be indicative of a leasing arrangement (*McNabb v. United States*, an unreported case (W.D. Wash. 1980, 47 AFTR 2d 81–513, 81–1 USTC par. 9143)), while a taxpayer's ability to include such a clause in an

[14]We observe, however, the individuals designated to make such withdrawals according to the original joint venture agreements were shareholders of both Freesen, Inc., and Freesen Equipment Co. Nevertheless, the fact that the "sponsoring joint venturer," i.e., Freesen, Inc., retained the right to unilaterally alter such designations is sufficient to support our conclusion that Freesen, Inc., had control over the funds.

agreement with an unrelated entity has been held to support a management contract characterization.[15]

Finally, we observe that many of the above characteristics indicating a lack of control over the venture as a whole by Freesen Equipment Co. also negate any reasonable characterization of the agreements in issue as joint venture agreements. After examining the record, we find the following items supportive of our conclusion that petitioners have failed to prove the existence of a joint venture: Freesen Equipment Co.'s lack of control over the entire topsoil removal operations; Freesen Equipment Co.'s lack of control over funds; and petitioners' failure to adduce evidence indicating that the joint venture status was so represented to third parties. *Luna v. Commissioner*, 42 T.C. 1067, 1077–1078 (1964).

With respect to the remaining risk of loss standard, petitioners have also failed to convince us that they bore a sufficient risk so as to defeat respondent's leasing characterization. Rule 142(a). The contracts for topsoil removal between Peabody and Freesen, Inc., were extremely detailed, providing for adjustments, for example, when the price of diesel fuel increased beyond the price prevailing when the contract was executed. Further, subject to monthly standby provisions whereby Freesen, Inc., was to be compensated for making specified equipment available, Freesen, Inc., was compensated for the use of equipment at hourly and monthly rates. Equipment and labor costs were billed to Peabody by Freesen, Inc., on a monthly basis. Freesen Equipment Co., however, received monthly *advances* from Freesen, Inc., for "equipment usage and the actual costs for service personnel, insurance, taxes, fuel and lubricants, and parts replaced or repaired on vehicles repaired or replaced under the services and maintenance provisions" of the joint venture agreements. Given the monthly *advance* billing procedures for equipment usage contained in the joint venture agreements, we conclude that petitioners were able to insulate themselves from the traditional risks associated with the operation of a business venture, which is indicative of a

[15] See *Meagher v. Commissioner*, *supra*. We also observe that the joint venture agreements are not between totally unrelated parties. The shareholders of Freesen Equipment Co. also owned at least 80 percent of Freesen, Inc.'s outstanding shares during the years in issue. In closely held corporations such as these, the existence of such substantial cross-ownership strongly conflicts with petitioners' claim that the joint venture agreements were the result of arm's-length bargaining.

leasing arrangement. *Amerco v. Commissioner*, *supra*; *McNabb v. United States*, *supra*.

We are mindful that, as with many business ventures, the record often contains elements supporting each party's position. See *Amerco v. Commissioner*, *supra*; *McNabb v. United States*, *supra*. Citing *Meagher v. Commissioner*, T.C. Memo. 1977-270, petitioners correctly observe that if the joint venture agreements are deemed leases for section 46(e)(3) purposes, they are "strange one[s], for the 'lessee' would be required to pay 'rent' only if its use of the property resulted in net profit." The fact, however, that the consideration paid for the use of property is a function of net profits, does not require a finding that a joint venture exists. Cf. sec. 1.761-1(a), Income Tax Regs.; see, e.g., *Grandview Mines v. Commissioner*, 282 F.2d 700 (9th Cir. 1960), affg. 32 T.C. 759 (1959); *Kingbury v. Commissioner*, *supra*; *McNabb v. United States*, *supra*. Further, the mere fact that considerations supportive of a party's position are present in the record does not require a finding in their favor. We must, instead, consider all of the surrounding circumstances in order to determine the intent of the parties as revealed in their actions and statements and the overall economic realities of the situation. *Amerco v. Commissioner*, *supra* at 670; *Kingsbury v. Commissioner*, *supra* at 1085. It is in this regard that petitioners have failed to carry their burden of proving the Commissioner's lease characterization to be erroneous.

The final matter concerning the Commissioner's determination that the joint venture agreements constitute leases for section 46(e)(3) purposes is petitioners' claim that this is inconsistent with respondent's stipulation that Freesen Equipment Co. qualified as, and chose to be, "an electing small business corporation" under subchapter S. In support thereof, petitioners assert that for section 1372(e)(5) purposes, the joint venture agreements were not considered leases producing rentals so as to disqualify Freesen Equipment Co.'s subchapter S election for the taxable years in issue. Respondent, in turn, contends that no inconsistency exists as section 1.1372-4(b)(5)(vi), Income Tax Regs., provides that "Payments * * * for the use of personal property do not constitute rents [for purposes of section 1372(e)(5)] if significant services are

rendered in connection with such payments," which respondent claims were present in the immediate setting.

After reviewing the parties' contentions in light of the record, we agree with respondent that there is no inconsistency between the Commissioner's lease determination and respondent's stipulation with respect to Freesen Equipment Co.'s subchapter S status. Petitioners presented sufficient evidence concerning the services rendered by Freesen Equipment Co.'s employees with respect to the leased equipment, e.g., the provision of personnel necessary to supervise the servicing of the equipment and the maintenance of service records, to support a conclusion that such services were "significant" for section 1.1372–4(b)(5)(vi), Income Tax Regs., purposes.[16] Accordingly, the Commissioner's determination that the joint venture agreements are leases for section 46(e)(3) purposes is sustained. Rule 142(a).

The next issue for decision is whether the method by which Freesen Equipment Co. leased the heavy construction equipment to Freesen, Inc., satisfied the noncorporate lessor provisions of section 46(e)(3). The Commissioner's determination that the arrangement did not qualify under section 46(e)(3) is presumptively correct (*Welch v. Helvering*, 290 U.S. 111, 115 (1933)), and petitioners bear the burden of proving it to be erroneous. Rule 142(a).

As discussed above, section 46(e)(3)[17] contains several qualification requirements concerning a noncorporate lessor's entitlement to investment tax credit with respect to the leased property. The parties agree that petitioners' entitlement to investment tax credit with respect to the heavy construction equipment purchased by Freesen Equipment Co. is tied to their satisfaction of the provisions of section 46(e)(3)(B). Further, the parties agree that the term of the leasing transaction[18] existing between Freesen Equipment Co. and Freesen, Inc., is less than 50 percent of the useful life of the leased property for section 46(e)(3)(B) purposes. The parties disagree, however, whether the statutory section 162 expense limitations contained in section 46(e)(3)(B) have been satisfied. In

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[16] See also *Lausmann v. Commissioner*, T.C. Memo. 1978–420.

[17] See note 7 *supra*.

[18] This designation follows from our holding for respondent that the joint venture agreements are leases for sec. 46(e)(3) purposes.

this regard, a noncorporate lessor qualifies for the investment tax credit allowed by section 38, only if:

> for the period consisting of the first 12 months after the date on which the property is transferred to the lessee the sum of the deductions with respect to such property which are allowable to the lessor solely by reason of section 162 (*other than rents and reimbursed amounts with respect to such property*) exceeds 15 percent of the rental income produced by such property. [Emphasis added.]

The parties' disagreement stems from differing interpretations of paragraph III.B. of the joint venture agreements which provide that:

> [Freesen] Equipment Co. shall bill [Freesen] Inc. monthly for advances on equipment usage and the actual costs for service personnel, insurance, taxes, fuel and lubricants, and parts replaced or repaired on vehicles repaired or replaced under the services and maintenance provisions of this agreement. [Freesen] Inc. shall pay [Freesen] Equipment Co. for such billings on a monthly basis.

Although respondent concedes that Freesen Equipment Co. was the entity which forwarded remuneration to third parties for section 162 expenses in a total sum during the relevant period in excess of the 15-percent limitation contained in section 46(e)(3)(B), respondent, nevertheless, contends that all of these section 162 expenditures constituted nonqualifying "reimbursements" under section 46(e)(3)(B) as the result of the advance billing clauses of the joint venture agreements. In support thereof, respondent observes that section 1.46–4(d)(3)(ii), Income Tax Regs., which was promulgated with explicit congressional authority under section 38(b), defines a "reimbursed amount" for section 46(e)(3)(B) purposes as "any expense for which the lessee or some other party is obligated to reimburse the lessor." Further, section 1.46–4(d)(3)(iii), Income Tax Regs., provides that "For purposes of the more-than-15-percent test, the gross income from rents of the lessor produced by the property is the total amount which is payable to the lessor by reason of the lease agreement other than reimbursements of section 162 expenses." Respondent, therefore, contends that Freesen Equipment Co.'s "gross income" for section 46(e)(3)(B) purposes is its share of the net profits, as computed under paragraph III. C. of the joint venture agreements. Yet, because Freesen Equipment Co. did not pay any

section 162 expenses with any funds other than those received under the advance billing clauses, respondent asserts that Freesen Equipment Co. had no nonreimbursed section 162 expenses; hence, petitioners are not entitled to their claimed investment tax credit.

Petitioners assert that the method by which Freesen Equipment Co. leased the heavy construction equipment to Freesen, Inc., fully satisfied the noncorporate lessor provisions of section 46(e)(3)(B). In support of their contention that the advances payable to Freesen Equipment Co. under paragraph III. B. of the joint venture agreements satisfied these requirements, they characterize these advances as:

> merely advances of profits under the agreement which enable [Freesen] Equipment Company to meet current expenses. The §162 expenses paid by [Freesen] Equipment Company (and those paid by Freesen, Inc.) were fully deducted from the gross receipts in determining net profit. The parties then divided the net profit according to the formula of paragraph III C. It would seem that a true reimbursed expense should be one that, as to the party reimbursed, did not affect that parties [sic] share of profits of losses.

In this regard, petitioners contend that respondent's analysis ignores the fact that all of the joint venture expenses were paid out of joint venture revenues.

We have already concluded that the joint venture agreements constitute leases for section 46(e)(3)(B) purposes; hence, we must now ascertain whether the more-than-15-percent test with respect to section 162 expenses has been satisfied. As discussed above, section 1.46–4(d)(3)(iii), Income Tax Regs., provides that "For purposes of the more-than-15-percent test, the gross income from rents * * * is the total amount which is payable to the lessor by reason of the lease agreement other than reimbursements of section 162 expenses." Pursuant to paragraph III. C. of the joint venture agreements, the total amount payable to the lessor, Freesen Equipment Co., is its stated share of the *net profits* (gross revenues less costs including section 162 expenses) resulting from performance of the contracts for topsoil removal. Freesen Equipment Co.'s share of the net profits, therefore, is the gross income figure to be utilized in determining whether the requirements of section 46(e)(3)(B) have been satisfied. Sec. 1.46–4(d)(3)(iii), Income Tax Regs. Yet, as Freesen Equipment Co.'s gross income for section 46(e)(3)(B) purposes is exclusive of any 162 expenses, it clearly

follows that Freesen Equipment Co. did not incur any section 162 expenses for section 46(e)(3)(B) purposes. This is further confirmed by the fact that the advances received by Freesen Equipment Co. under paragraph III. B. of the joint venture agreements were based solely upon the section 162 expenses.

Finally, we observe that the legislative history accompanying the enactment of section 46(e)(3) confirms our conclusion that petitioners are not entitled to their claimed investment tax credit. As we remarked in *Ridder v. Commissioner*, 76 T.C. 867, 872 (1981),

> In general, Congress was concerned that individuals might be tempted to use investment credits to finance the acquisition and leasing of depreciable property as tax shelters. S. Rept. 92–437 (1971), 1972–1 C.B. 559, 583. Thus, Congress tried to make investment credits available only to those noncorporate lessors actually using the property in question in an active business. These were determined to be lessors who had themselves manufactured or produced the property, and short-term lessors. Conversely, Congress wanted to deny investment credits to purchaser-lessors involved in mere financing arrangements without the risks and obligations associated with an ongoing trade or business. [Fn. ref. omitted.]

In the instant case, as all of the remuneration forwarded to third parties by Freesen Equipment Co. for section 162 expenses constituted advances of its share of the net profits under the joint venture agreements, it is apparent that the transaction in issue was a "mere financing arrangement" and that petitioners were insulated from the traditional risks and obligations associated with an ongoing trade or business. Accordingly, the Commissioner's disallowance of petitioners' claimed investment tax credit is sustained.

The final issue for decision is whether the heavy construction equipment owned by Freesen Equipment Co. was subject to a lease for the purposes of section 57(a)(3), so as to require that any depreciation claimed by petitioners in excess of straight line be treated as a tax-preference item. In the notices of deficiency mailed to petitioners, the Commissioner determined that such heavy construction equipment was subject to a lease for section 57(a)(3) purposes. The Commissioner's determination is presumptively correct. *Welch v. Helvering*, 290 U.S. 111, 115 (1933), and petitioners bear the burden of proving it to be erroneous. Rule 142(a).

We have already decided that the heavy construction equipment was subject to a lease for section 46(e)(3) purposes and that the transactions in issue failed to satisfy the noncorporate lessor provisions contained therein. The term "lease," as contained in sections 46(e)(3) and 57(a)(3), is not defined by statute. Petitioners' cursory review of this issue offers no convincing reasons why our prior holdings in favor of respondent do not compel a similar result with respect to this issue. Accordingly, based upon the parties' stipulations,[19] the Commissioner's determination that such accelerated depreciation deductions constitute items of tax preference is sustained. Rule 142(a).

Decision will be entered under Rule 155.

CLOUGHERTY PACKING COMPANY, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 1954–82. Filed May 20, 1985.

Petitioner's wholly owned subsidiary incorporated a wholly owned captive insurance subsidiary (Lombardy). Petitioner negotiated coverage for its workers' compensation insurance liabilities with Fremont, an unrelated insurance carrier. In addition, Fremont negotiated with petitioner to have Lombardy reinsure portions of petitioner's risk which was insured with Fremont. Under this agreement, 92 percent of the premiums paid by petitioner to Fremont were ceded to Lombardy. *Held*, petitioner failed to shift 92 percent of its risk of loss; therefore, 92 percent of its premiums paid to Fremont is not deductible as an ordinary and necessary business expense for insurance. *Carnation Co. v. Commissioner*, 71 T.C. 400 (1978), affd. 640 F.2d 1010 (9th Cir. 1981), followed.

Brian J. Seery, for the petitioner.
Marshall W. Taylor, for the respondent.

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[19] See note 6 *supra*.

OPINION

GOFFE, *Judge*: The Commissioner determined deficiencies in petitioner's Federal income tax for the taxable years ended July 29, 1978, and July 28, 1979, in the amounts of $370,944 and $628,202, respectively. The sole issue for decision is whether petitioner is entitled to deduct, as an ordinary and necessary business expense, the entire amount paid to an unrelated insurance carrier as insurance premiums for workers' compensation coverage where the unrelated carrier reinsures 92 percent of such risk with the wholly owned captive insurance company of petitioner's wholly owned subsidiary and cedes 92 percent of the premiums to the captive.

All of the facts were stipulated. The stipulation of facts and exhibits are incorporated by this reference. Petitioner Clougherty Packing Co. was incorporated under the laws of California on December 31, 1945. At the time of filing the petition, its principal place of business was Los Angeles, California. It filed its corporate Federal income tax returns for the taxable years ended July 29, 1978, and July 28, 1979, with the Internal Revenue Service Center in Fresno, California. The returns were not consolidated returns with its subsidiaries.

During the taxable years involved, petitioner owned all of the issued and outstanding stock of Clougherty Packing Co. of Arizona which was incorporated under the laws of Arizona on July 26, 1977. Petitioner's Arizona subsidiary, in turn, owned all of the issued and outstanding stock of Lombardy Insurance Corp. (Lombardy). Lombardy was incorporated under the laws of Colorado on November 24, 1976, pursuant to the Colorado Captive Insurance Company Act. During the taxable years involved, Lombardy was a corporation in good standing with the Department of Insurance of the State of Colorado.

Before 1970 and continuing through the taxable years involved, petitioner employed more than 1,000 workers in California which required that petitioner obtain coverage under the California workers' compensation laws. It was engaged in slaughtering and meat processing, and numerous workers' compensation claims were filed against petitioner by its employees. The employees claimed that they contracted brucellosis, an industrial disease connected with meat processing. Section 3700 of the California Labor Code required employers to maintain workers' compensation coverage by one

or more insurers authorized to write compensation insurance in California, or to secure from the California Director of Industrial Relations a certificate of consent to self-insure. Prior to 1978, petitioner elected, in part, to be self-insured with respect to workers' compensation coverage and it, therefore, secured a certificate of consent from the California Director of Industrial Relations. Liability in excess of the limited self-insurance was covered by insurance policies with insurers qualified to do business in California. The per claim limits of petitioner's self-insurance and the California insurance carriers who carried the excess over petitioner's self-insurance coverage from July 31, 1971, through July 30, 1977, were as follows:

Year	*Self-insurance*	*Coverage by carrier in excess of self-insurance*
July 31, 1971	$35,000	Employers Surplus Lines, Inc.—all in excess of $35,000
July 29, 1972	[1]50,000	Reserve Insurance—excess of $35,000 up to $50,000[2]
	50,000	Employers Reinsurance—all in excess of $50,000
July 27, 173–Aug. 2, 1975	35,000	Fremont Indemnity Co.—all in excess of $35,000
July 31, 1976	75,000	American Bankers Ins. Co. of Florida—all in excess of $75,000
July 30, 1977	100,000	Puritan Insurance Co.—all in excess of $100,000

In order to obtain State certification for self-insurance, petitioner was required to deliver securities to the California State Treasurer as security for potential workers' compensation liabilities. The costs of such securities deposited with the California State Treasurer during the fiscal years ended July 31, 1971, through July 30, 1977, were as follows:

FYE—	*Amount*
July 31, 1971	$638,269
July 29, 1972	638,269
July 27, 1973	638,269
Aug. 3, 1974	638,269
Aug. 2, 1975	857,110

[1]and[2] The parties stipulated this schedule and did not explain this discrepancy.

FYE—	*Amount*
July 31, 1976	$857,110
July 30, 1977	857,110

Earnings from the securities inured to the benefit of petitioner while on deposit with the State.

From January 1974 to October 1976, petitioner maintained its own staff of adjusters to handle claims for workers' compensation. After October 1976, such claims were handled by an independent insurance broker, Frank B. Hall Management Co. (Hall), a nationwide brokerage firm. During 1976, Hall prepared and submitted to petitioner a detailed report entitled "Captive Insurance Study for Clougherty Packing Co." The report proposed that petitioner insure its liabilities for workers' compensation directly with its own captive insurance company organized under the laws of Colorado. This proposal was not adopted on advice of petitioner's counsel because of legal and regulatory problems under California law. Rather than establish a direct insurance captive, the management of petitioner decided to establish a Colorado captive to reinsure some of petitioner's risk. The management concluded that a captive insurance arrangement would reduce the cost of its liabilities for workers' compensation coverage by: (1) Increasing investment income above the amount received on the securities deposited with the State Treasurer of California; (2) eliminating the underwriting costs paid to outside insurance carriers; and (3) receiving favorable Federal tax treatment for the captive insurance company subsidiary which treatment is available to all insurance companies.

The articles of incorporation for Lombardy were filed in Colorado on November 24, 1976, but business operations did not commence until a later date. Lombardy was capitalized for $1 million, as required by the Colorado Commissioner of Insurance. Colorado statutes required a minimum capitalization of $750,000. On July 27, 1977, the $1 million of capital was fully paid in, from which $750,000 was used to purchase a certificate of deposit in a Colorado bank, jointly held by Lombardy and the Colorado Division of Insurance. During September 1977, Hall proposed to petitioner's management that Lombardy join a reinsurance underwriting group. As of September 1977, Lombardy was not yet operating and the

management of petitioner rejected the group reinsurance underwriting proposal.

Petitioner and Fremont Indemnity Co. (an unrelated insurer licensed to write workers' compensation insurance in California, hereinafter referred to as Fremont) negotiated for a captive insurance program for petitioner.

On October 25, 1977, Fremont offered, in writing, to provide a captive reinsurance program for petitioner, the pertinent terms of which were as follows:

1. The cost to be 5 percent of the annual earned premium, plus premium taxes, bureau fees, and nonincidental costs.

2. The "Clougherty Captive Company" (as Fremont identified it in its offer) would assume the first $100,000 of any risk, with coverage in excess of $100,000 for any risk being furnished by Fremont.

3. All funds were to be remitted to "Clougherty's captive" monthly, based on remittances by petitioner to Fremont, less costs and deficiencies in collateral.

On October 31, 1977, petitioner's attorney accepted Fremont's offer on behalf of petitioner with some "clarifications" agreed to by telephone on October 28, 1977. The name, Lombardy, was substituted for Clougherty captive. Lombardy would reinsure the first $100,000 of any risk insured with Fremont. In essence, Fremont would be assuming the risk up to $100,000 but would reinsure that risk with Lombardy. "The turn around time on money, both from Fremont to Lombardy and from Lombardy to Fremont, will be no more than five days."

During December 1977, Hall requested the Colorado Insurance Division to perform an organizational examination of Lombardy which was accomplished and, on December 30, 1977, the Colorado Division of Insurance issued to Lombardy a certificate of authority to conduct business as a captive insurance company in the State of Colorado.

The officers and directors of Lombardy have also been officers or employees of petitioner or Hall since the organization of Lombardy and throughout the taxable years involved. During the same taxable periods, Lombardy's sole business was the reinsurance of petitioner's workers' compensation coverage. Lombardy has never owned or leased any real property and the address of its principal office during the

taxable years involved was the address of Hall. Lombardy had no employees but, instead, conducted its day-to-day business through employees of Hall pursuant to a management agreement between Lombardy and Hall.

During April 1978, petitioner insured its workers' compensation coverage for 1 year with Fremont, effective January 1, 1978. Fremont notified the State of California that it had issued a valid workers' compensation insurance policy in a form approved by the California Insurance Commissioner to petitioner for 1978 and 1979. The State of California Workers' Compensation Insurance Rating Bureau set the premium rate for the years in question. Lombardy agreed to reinsure the first $100,000 per occurrence for all of petitioner's risks insured by Fremont. In addition, Fremont agreed to cede (transfer) to Lombardy 92 percent of the premiums it received from petitioner. The reinsurance agreement was effective January 1, 1978, but was executed by Lombardy on February 3, 1978, and by Fremont on March 22, 1978. The Colorado Insurance Commissioner approved the premium rates and reinsurance cessions for the years involved. Under the reinsurance agreement, Lombardy was required to and did secure a $200,000 irrevocable letter of credit to be held by Fremont as security for unpaid open losses and unearned premiums. In addition, Lombardy agreed to deposit securities with the California State Treasurer to cover demands for statutory reserves made upon Fremont by the California Department of Insurance.

There was no agreement or understanding between petitioner, its wholly owned subsidiary in Arizona, Hall, or Fremont that petitioner would indemnify Fremont, that it would pay additional capital into Lombardy, or that it would take any steps, direct or indirect, to assure that Lombardy would perform its obligations under its reinsurance agreement with Fremont. The premium paid by petitioner to Fremont was set by the Workers' Compensation Insurance Rating Bureau of the State of California; the rates for reinsurance cessions from Fremont to Lombardy were negotiated between Fremont and Lombardy, but had to be approved by the Insurance Commissioner for the State of Colorado.

Following the effective date of the insurance and reinsurance arrangement, January 1, 1978, petitioner was no longer

required to deposit securities with the State Treasurer of California to cover workers' compensation claims arising after January 1, 1978. Subsequent to being informed that petitioner was no longer self-insured, the State of California audited the self-insurance reserves of petitioner and demanded an increase in the amount of securities on deposit for pre-1978 claims. Later, the reserves on deposit with the State of California were reduced as petitioner's pre-1978 liabilities were settled and paid. The values of the securities on deposit for the taxable years ended July 29, 1978, and July 28, 1979, were $1,489,644 and $1,120,303, respectively.

During the taxable years ended July 29, 1978, and July 28, 1979, petitioner accrued and deducted as premiums for workers' compensation insurance $840,000 and $1,457,500, respectively. During the taxable years ended July 29, 1978, and July 28, 1979, Fremont paid to Lombardy $772,900 and $1,340,000,[3] respectively, as reinsurance premiums.

The Commissioner, in the statutory notice of deficiency, disallowed that portion of petitioner's deductions for premiums on workers' compensation insurance which represented the "reinsurance premiums" paid by Fremont to Lombardy in the amounts of $772,800 and $1,340,900 for the taxable years ended July 29, 1978, and July 28, 1979, respectively.

The first captive insurance company case submitted to this Court was *Carnation Co. v. Commissioner*, 71 T.C. 400 (1978), affd. 640 F.2d 1010 (9th Cir. 1981). An appeal in the instant case would also be to the Court of Appeals for the Ninth Circuit. *Carnation Co. v. Commissioner*, *supra*, was submitted to the Court upon cross motions for summary judgment and the instant case was submitted fully stipulated.

Carnation and an unrelated insurance company, American Home Assurance Co. (American Home) entered into an insurance agreement, and American Home simultaneously reinsured 90 percent of Carnation's risk with Carnation's wholly owned Bermuda subsidiary, Three Flowers Assurance Co. (Three Flowers). We held that Carnation was not entitled to deduct as insurance premiums 90 percent of its payments to American Home. We based our holding upon *Helvering v. Le Gierse*, 312 U.S. 531 (1941).

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[3]There is a small discrepancy between the amounts stipulated by the parties and the amounts shown in the statutory notice. The discrepancy has no effect on the outcome.

Le Gierse involved the exclusion from the gross estate of a portion of the insurance proceeds payable to decedent's daughter. Shortly before her death, the decedent purchased from an unrelated insurance company a single premium life insurance policy, naming her daughter as beneficiary. The decedent simultaneously purchased a single premium lifetime annuity payable to herself from the same unrelated insurance company. The insurance company agreed to issue the life insurance policy only upon the condition that petitioner simultaneously purchase the annuity. The Court held that the life insurance and annuity transaction were not separate and distinct transactions and should be considered together. It reasoned that "annuity and insurance are opposites; in this combination the one neutralizes the risk customarily inherent in the other. From the company's viewpoint, insurance looks to longevity, annuity to transiency." 312 U.S. at 541. The Court went on to hold that the combination of agreements did not represent a shifting of the risk of loss inherent in insurance; therefore, the proceeds received by the daughter did not represent an amount receivable as insurance.

We applied *Le Gierse* to the facts in *Carnation* as follows:

> By entering into the agreements in issue, Carnation attempted to shift its risk of property loss due to fire, lightning, vandalism, malicious mischief, sprinkler leakage, flood, and earthquake shock. The agreements attempted ultimately to shift 90 percent of the risk to Three Flowers and 10 percent of the risk to American Home. In the event of a covered casualty, the loss suffered by Carnation ultimately would be borne 90 percent by Three Flowers and 10 percent by American Home. The agreement to purchase additional shares of Three Flowers by Carnation bound Carnation to an investment risk that was directly tied to the loss payment fortunes of Three Flowers, which in turn were wholly contingent upon the amount of property loss suffered by Carnation. The agreement by Three Flowers to "reinsure" Carnation's risks and the agreement by Carnation to capitalize Three Flowers up to $3 million on demand counteracted each other. Taken together, these two agreements are void of insurance risk. As was stated by the Court in *Le Gierse*, "in this combination the one neutralizes the risk customarily inherent in the other." 312 U.S. at 541. [71 T.C. at 409.]

Two U.S. District courts have followed the rationale of *Carnation* to reach the same result, *Stearns-Roger Corp., Inc. v. United States*, 577 F. Supp. 833 (D. Colo. 1984), and *Beech Aircraft Corp. v. United States*, an unreported case (D. Kan. 1984, 54 AFTR 2d 84–6173, 84–2 USTC par. 9803). One U.S.

District Court applied the rationale of *Carnation*, but reached a contrary result on factual distinctions. *Crawford Fitting Co. v. United States*, 606 Fed. Supp. 136 (N.D. Ohio 1985).

Respondent, in the instant case, urges us to adopt a concept referred to as "economic family." It is apparent from the opinions in *Stearns-Roger* and *Beech Aircraft* that expert witnesses testified for the Government in support of its "economic family" theory. We have no such evidence in the case before us and we find it unnecessary to embrace such a concept because we conclude that the instant case can be decided within the parameters of *Carnation*.

Petitioner, in the instant case, bases its position upon the following arguments: (1) Disallowance of the premiums violates the recognition of legitimate business transactions between separate entities who are members of an affiliated group; (2) other risk shifting among members of an affiliated group is recognized for tax purposes; and (3) our opinion in *Carnation* is either wrong or the facts in *Carnation* are distinguishable from the facts before us in this case. We will discuss these points in inverse order.

We cannot agree that our opinion in *Carnation* was incorrect. The decision was affirmed and the rationale of *Carnation* has been applied by three separate District Courts. *Carnation* has not been criticized by any other courts. We continue to adhere to such rationale and have been shown nothing to convince us that *Carnation* was incorrect or should not be followed.

We likewise hold that the operative facts in the instant case are indistinguishable from the facts in *Carnation*. Petitioner relies heavily upon the fact that it paid in $1 million of capital to Lombardy and had no arrangement to indemnify Fremont for losses. For this fact to be critical, the comparable facts of the funding of the captive in *Carnation* must be critical. They are not. The rationale of *Carnation* is that there was no shifting of 90 percent of the parent's risk of loss. Without quoting at length from our opinion in *Carnation*, suffice it to say that the agreement of Carnation to provide additional capital to Three Flowers was only one of the several factors upon which we concluded there was not the requisite shifting of risk to constitute insurance for purposes of deducting insurance premiums. The financial viability of the captive

insurance subsidiary is not controlling. The test continues to be whether, considering all of the facts, the risk of loss was shifted away from the taxpayer who seeks to deduct insurance premiums.

The interdependence of all of the agreements is relevant here as the Supreme Court held that it was in *Le Gierse* (see discussion on page 955 *supra*) and as we held that it was in *Carnation*, see quote at page 955 *supra*. The execution dates certainly confirm their interdependence as demonstrated below:

Feb. 3, 1978	Lombardy executed reinsurance agreement with Fremont effective Jan. 1, 1978
Mar. 22, 1978	Fremont executed reinsurance agreement which Lombardy executed on Feb. 3, 1978
Apr. 24, 1978	Fremont issued insurance policy to petitioner covering the period from Jan. 1, 1978, to Jan. 1, 1979, effective Jan. 1, 1978
1978	Fremont notified the Division of Self Insurance of the State of California that it had issued a valid workers' compensation insurance policy to petitioner for the years 1978 and 1979
Jan. 24, 1979	The insurance policy issued by Fremont to petitioner is renewed for 1 year, effective Jan. 1, 1979

Petitioner argues that other shifts of risk among members of an affiliated group are recognized for tax purposes. That is true. Indeed, that is one of the reasons we are reluctant to embrace the "economic family" concept urged by respondent, because such a concept cannot be reconciled with types of transactions between related entities other than insurance.

Shifting of risk in transactions other than insurance are simply not relevant here. We are concerned only with the deductibility of insurance premiums. The cost of insurance is represented by the insurance premium. Accordingly, to deduct insurance premiums it is essential to decide whether the relationship giving rise to the payment constitutes insurance.[4]

The limit of our inquiry is the deductibility of premiums paid for insurance coverage. We pointed out in *Carnation* at

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[4] This means the "true assumption of the risk of loss." *Surety Insurance Co. of California v. Commissioner*, T.C. Memo. 1980-70.

page 413 of 71 T.C. that we did not see how *Le Gierse* has any application beyond insurance premiums. Our holding in *Carnation* and our holding here is likewise limited to the deduction for insurance premiums. It has long been decided that a taxpayer cannot deduct as insurance premiums amounts set aside in its own possession to compensate itself for perils which are generally the subject of insurance. In *Pan-American Hide Co. v. Commissioner*, 1 B.T.A. 1249, 1250 (1925), the deduction was disallowed because the law did not permit a taxpayer to deduct as an expense an amount it feared may some day be called upon to spend. The law has not changed. Even if the taxpayer cannot obtain insurance to cover the peril, the amount set aside as self-insurance is not deductible. *L.A. Thompson Scenic Railway v. Commissioner*, 2 B.T.A. 664 (1925).

It is undisputed that the definition of insurance means the shifting of risk and that the insurance premium is the cost of providing for the shifting of risk. See *Steere Tank Lines, Inc. v. United States*, 577 F.2d 279 (5th Cir. 1978). The insurance premium is the measure by which unrelated parties calculate the cost of the risk being assumed by the insurance company. The agreement by which Lombardy was to receive from Fremont 92 percent of the premiums which petitioner paid to Fremont, the unrelated party, measured that portion of the total risk of Fremont assumed by Lombardy, petitioner's captive insurance company. The question is, therefore, whether this 92 percent of the premiums paid by petitioner is, in reality, insurance premiums. Under the definition of insurance, such payments do not *constitute* insurance premiums unless they are paid to shift risk away from the taxpayer who seeks to deduct them. This portion of the amounts paid to Fremont which were ceded to Lombardy must *constitute* insurance premiums to be deductible. They are not insurance premiums unless they pay for a shift away from petitioner of 92 percent of petitioner's risk of loss.

When petitioner sustains losses covered by its workers' compensation insurance, 92 percent is sustained by Lombardy. Accordingly, because petitioner, through its wholly owned Arizona corporation, owns all of Lombardy, it has not shifted the risk of sustaining such losses to unrelated parties in exchange for insurance premiums because the premiums were

paid to the wholly owned subsidiary of its wholly owned subsidiary. We reiterate that it is unnecessary to use the term "economic family" in resolving the issue because it might foster a theory which would be extended to other areas of the tax law.[5] We hasten to point out, nevertheless, that parents and wholly owned subsidiaries are involved in *Carnation* and here. We express no opinion, however, as to situations where the taxpayer does not completely own the subsidiary.

We found in *Carnation*, as we find here, that to the extent the risk was not shifted, insurance does not exist and the payments to that extent are not insurance premiums. The measure of the risk shifted is the percentage of the premium not ceded. This is nothing more than a *recharacterization* of the payments which petitioner seeks to deduct as insurance premiums.

Petitioner argues that our holding in *Carnation* disregards the separate nature of the corporate entities involved, citing *Moline Properties v. Commissioner*, 319 U.S. 436 (1943). Such an argument is contrary to what we said at page 408 of 71 T.C.:

> The foregoing analysis of *Le Gierse* reveals that the Court considered together two related agreements between unrelated parties. The Court's opinion is not premised on its disregarding the separateness of the parties to the agreements. *We conclude that the application of Le Gierse to the facts of the instant case will be equally valid whether or not Three Flowers and Carnation are separate entities for tax purposes.* [Emphasis added.]

We reaffirm the quotation from *Carnation* that if the holding of *Le Gierse* applies, it applies regardless of whether or not Carnation and Three Flowers were considered separate entities for tax purposes.

It has been 6 years since we decided *Carnation*. The separate entity argument was argued and disposed of in *Beech Aircraft Corp. v. United States*, *supra*, and *Crawford Fitting Co. v. United States*, *supra*. The taxpayers continue to argue the theory in undecided cases which have been submitted to us. We, therefore, deem it appropriate to explain in more detail why we conclude that the separate nature of the corporate entities has not been disregarded in applying *Le Gierse*.

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[5] At page 966 *supra*, we pointed out that there was no testimony in this case as to "economic family." We do not imply that such a concept might be considered in situations other than captive insurance if expert testimony were offered.

There are numerous situations in the tax law, both statutory and case law, where the separate nature of the entity is not disregarded but the transaction, as cast between the related parties, is reclassified to represent something else, e.g., reasonable compensation or dividend, loans or contributions to capital, loans or dividends, deposits or payments, or other recharacterization such as permitted under section 482, Internal Revenue Code of 1954, as amended. We have done nothing more in *Carnation* and here but to reclassify, as nondeductible, portions of the payments which the taxpayers deducted as insurance premiums but which were received by the taxpayer's captive insurance subsidiaries.

The only insurance business which Lombardy had was that of petitioner. We expressly decline to decide in this case how the result might be affected, if at all, if the captive insurance company had insurance business from unrelated customers.

We, therefore, under the authority of *Carnation*, sustain respondent's determination in denying 92 percent of petitioner's deductions for insurance premiums on its workers' compensation insurance. To reflect an alternative deduction which respondent does not dispute,

Decision will be entered under Rule 155.

Reviewed by the Court.

DAWSON, FAY, SIMPSON, STERRETT, CHABOT, PARKER, and COHEN, *JJ.*, agree with the majority opinion.

NIMS, *J.*, did not participate in the consideration of this case.

WHITAKER, *J.*, concurring: As the majority points out, a taxpayer which self-insures cannot deduct sums set aside as a reserve for payment of unmatured claims, whether or not roughly equivalent to premiums for insurance against the particular risks. *Pan-American Hide Co. v. Commissioner*, 1 B.T.A. 1249, 1250 (1925); *L.A. Thompson Scenic Railway v. Commissioner*, 2 B.T.A. 664 (1925). By analogy see *Crescent Wharf & Warehouse Co. v. Commissioner*, 59 T.C. 751 (1973), revd. 518 F.2d 772 (9th Cir. 1975). It is too obvious for discussion that generally a taxpayer cannot be allowed to do

indirectly through a wholly owned subsidiary that which it is prohibited from doing directly. Hence by merely qualifying a subsidiary as an insurance company, a parent cannot deduct sums equivalent to insurance premiums which it pays to its subsidiary. And the same tax analysis must apply where the premiums are paid indirectly to the subsidiary as reinsurance. *Carnation* (*Carnation Co. v. Commissioner*, 71 T.C. 400 (1978), affd. 640 F.2d 1010 (9th Cir. 1981)) in my judgment really stands for this proposition and it is time we said so. It is on this basis that I would hold petitioner is precluded from deducting the premiums paid to Fremont to the extent of the 92 percent that by prearrangement was returned to its subsidiary Lombardy, the sole business of which was reinsurance of petitioner's insurance with Fremont. We do not have before us other fact situations such as those postulated by the dissent. Resolution of those different and more difficult issues should await another day. "Sufficient unto the day is the evil thereof." 6 Matthew 34.

HAMBLEN, *J.*, concurring: I concur in the result reached in this opinion. However, I do not agree with the basis on which this result was reached and believe this opinion has obscured the longstanding analysis of *Helvering v. Le Gierse*, 312 U.S. 531 (1941).

Helvering v. Le Gierse, supra at 539, describes a true insurance arrangement as requiring "risk-shifting and risk-distribution." The Court found in that instance that there was no risk-shifting because:

> Here the total consideration was prepaid and exceeded the face value of the "insurance" policy. The excess financed loading and other incidental charges. Any risk that the prepayment would earn less than the amount paid to respondent as an annuity was an investment risk similar to the risk assumed by a bank; it was not an insurance risk as explained above. [*Helvering v. Le Gierse, supra* at 542.]

Subsequently, this Court in *Carnation Co. v. Commissioner*, 71 T.C. 400 (1978), affd. 640 F.2d 1010 (9th Cir. 1981), had the opportunity to examine *Helvering v. Le Gierse, supra*, in the context of a wholly owned subsidiary which reinsured 90 percent of the insurance risk assumed by an unrelated third

party insurance company. In *Carnation Co. v. Commissioner, supra*, the parent corporation had entered into an agreement with the subsidiary which permitted the subsidiary to receive an additional $2,880,000 capital contribution on demand. Clearly, the implication was that, if the premiums paid were inadequate to cover the insurance risks, the insured would, in effect, make up at least a portion of the deficiency through additional capital contributions. We found that the agreement to provide additional capital contributions bound Carnation to an investment risk which neutralized the insurance risk. *Carnation Co. v. Commissioner, supra* at 409.[1] Consequently, we held that there was no risk-shifting to the extent of the reinsurance arrangement.

While I agree with the analysis in *Carnation Co. v. Commissioner, supra*, I cannot agree that the conclusion of that case is controlling here. Unlike the situation in *Carnation Co. v. Commissioner, supra*, there was no requirement that petitioner contribute additional sums to Lombardy. The findings of fact (*supra* p. 953) specifically state:

> There was no agreement or understanding between petitioner, its wholly owned subsidiary in Arizona, Hall, or Fremont that petitioner would indemnify Fremont, that it would pay additional capital into Lombardy, or that it would take any steps, direct or indirect, to assure that Lombardy would perform its obligations under its reinsurance agreement with Fremont.

Under the circumstances, I simply cannot agree that no risk-shifting was involved here to the extent of the reinsurance. Petitioner paid sums which were ultimately received by Lombardy, and Lombardy assumed the risk that these sums would not be sufficient to cover all of its liability.

While ostensibly rejecting the "economic family" concept, the opinion in this case seems to me to rely on a similar analysis in order to support the conclusion that there was no risk-shifting. The economic family concept is described in Rev. Rul. 77–316, 1977–2 C.B. 53, 54, which provides in pertinent part:

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[1] This opinion states that the agreement to provide additional capital was only one factor of several which were considered in the determination made in *Carnation Co. v. Commissioner*, 71 T.C. 400 (1978), aff'd. 640 F.2d 1010 (9th Cir. 1981). However, review of that opinion discloses to me no other factor articulated as a basis for the opinion.

the insuring parent corporation and its domestic subsidiaries, and the wholly owned "insurance" subsidiary, though separate corporate entities, represent one economic family with the result that those who bear the ultimate economic burden of loss are the same persons who suffer the loss. To the extent that the risks of loss are not retained in their entirety by * * * or reinsured with * * * insurance companies that are unrelated to the economic family of insureds, there is no risk-shifting or risk-distribution, and no insurance, the premiums for which are deductible under section 162 of the Code.

In the situation where the insurer is wholly owned by the insured, either directly or indirectly, I can see little difference between the economic family concept described in the revenue ruling and the conclusion in this case that (p. 958):

When petitioner sustains losses covered by its workers' compensation insurance, 92 percent is sustained by Lombardy. Accordingly, because petitioner, through its wholly owned Arizona corporation, owns all of Lombardy, it has not shifted the risk of sustaining such losses to unrelated parties in exchange for insurance premiums because the premiums were paid to the wholly owned subsidiary of its wholly owned subsidiary.

In any event, both analyses appear to be directly contrary to the holding of *Moline Properties v. Commissioner*, 319 U.S. 436 (1943), and may not, in my opinion, be sustained on that basis alone.[2] The *Moline Properties* issue is unnecessarily injected into this case via the economic family concept analogy.

My conclusion in this case is that the insurance arrangement with Lombardy did effectively shift the insured risk from petitioner to Lombardy. However, the arrangement is not a true insurance arrangement because there is no risk distribution. Risk distribution may be described as:

a method of dispelling the danger of a potential loss *by spreading its cost throughout a group.* By diffusing the risks through a mass of separate risk shifting contracts, the insurer casts his lot with the law of averages. [*Commissioner v. Treganowan*, 183 F.2d 288, 291 (2d Cir. 1950). Emphasis added.]

Clearly, there is no risk distribution here because there is only one insured and, consequently, there can be no spreading of

[2] See Tinsley, Why Revenue Ruling 77-316 Is Wrong: A Captivating Argument, 9 Jour. of Corp. Tax. 142 (1982).

the exposure.[3]

Finally, the opinion notes that it will save for another day resolution of the insurance issue where a subsidiary insures risks other than those of its parent. I respectfully submit, however, that this merely begs the question, because one issue will be there, as it is here, whether a distribution as well as a shifting of risk has occurred. Accordingly, I would apply here the insurance definition in *Helvering v. Le Gierse, supra*, and resolve the issue on that basis. Hopefully, we can then put to rest the economic family concept, at least in this Court.[4]

JACOBS, *J.*, concurring: I concur in the result reached by the majority but not in the majority's reasoning.

As the majority recognizes, a deduction for contributions to reserves for self-insurance is not allowable under section 162. What one may not do directly cannot be done circuitously. On the facts before us—a wholly owned subsidiary whose only business is that of insuring its ultimate parent—the circuitous attempt to side-step the prohibition against a deduction for self-insurance is obvious. To borrow from an old television comedy program, a rabbit wearing a sign that reads "chinchilla," in a cage marked "chinchilla cage," and eating food denoted as "chinchilla food," is nevertheless a rabbit.

I do not espouse the economic family theory (as apparently adopted by the majority) since to do so would deny a deduction for a premium paid under an otherwise valid insurance arrangement solely because of the relationship between the insured and the insurer. Nor do I subscribe to the position that, in every case in which the insured's policy is the only policy issued by the insurance company, the lack of risk distribution, standing alone, is a sufficient ground for denying a deduction for the premium paid. My position is simply that where both the insurance company is ultimately wholly owned

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[3] Although any employee entitled to compensation may enforce the liability of any insurer under sec. 3753 of the California Labor Code, it is the employer's obligation to the employees, i.e., the risk, under sec. 3600 of the California Labor Code, which is insured.

[4] Indeed the Internal Revenue Service has clarified its position in Rev. Rul. 77-316, 1977-2 C.B. 53, and eliminated the application of the economic family concept where there are numerous insured shareholders, none of whom owns a controlling interest in the insurance corporation. See Rev. Rul. 80-120, 1980-1 C.B. 41; Rev. Rul. 78-338, 1978-2 C.B. 107.

by the insured and the only policy issued by the insurance company is to its parent corporation, it defies logic to consider such an arrangement as anything other than self-insurance. What may be the outcome in another case presenting different facts must be left for another time.

GERBER, *J.*, dissenting: The majority has transcended the natural boundaries of the holding in *Carnation Co. v. Commissioner*, 71 T.C. 400 (1978), affd. 640 F.2d 1010 (9th Cir. 1981), and has incorrectly applied the rule of law in *Helvering v. Le Gierse*, 312 U.S. 531 (1941), upon which *Carnation* is based. I further disagree with the majority's statement that "the operative facts in the instant case are indistinguishable from the facts in *Carnation*." In essence, the majority has adroitly avoided the result which should occur by applying *Carnation* and *Le Gierse* to the facts of this case.

Le Gierse, a narrowly drawn holding of limited application, stands for the principle that an insurance relationship does not exist where the risk does not shift from the "insured" to an insurer. In *Le Gierse*, offsetting annuity and life insurance contracts, measured by the same life, were found to be insufficient to transfer or shift the risk of loss from the insured to the insurer.

In *Carnation*, a wholly owned offshore captive insurance company reinsured 90 percent of the risk which its parent placed with an unrelated insurer. Only $120,000 of $3 million in authorized capital had been contributed to the captive. The unrelated insurer would not reinsure with Carnation's captive unless Carnation agreed to pay the $2,880,000 unpaid portion of the captive's capital upon demand, if the captive was required to pay claims on the risks of Carnation. The essence of these transactions is that Carnation would be paying claims against it by means of "contributions" to capital as the claims arose. Thus, the contract to insure followed by the 90-percent reinsurance with the captive subsidiary was offset by Carnation's agreement to pay additional capital or indemnify for its own losses. This application of *Le Gierse* is axiomatic inasmuch as no risk shifted to the captive. It is to be noted, however, that "The key was that [the unrelated insurer] refused to enter into the reinsurance contract with [the captive subsidiary of

Carnation] unless Carnation agreed to capitalize [the captive]." *Carnation Co. v. Commissioner*, 640 F.2d at 1013.

Since the transaction in *Carnation* did not result in a shifting of the risk, 90 percent of the premiums (the amount reinsured) did not constitute insurance but was self-insurance[1] and not deductible. This result could be and properly was accomplished without questioning the separate corporate existence of the captive subsidiary. The validity of the insurance and reinsurance contracts was not in question. Further, no determinations or findings were made concerning the captive's status as an insurance company, either under the law of the situs or within the meaning of sections 801 et seq. of subchapter L, chapter 1, Internal Revenue Code.

The majority would now have us believe that the indemnification agreement in *Carnation* was not a critical factor and instead focuses our attention on the conclusion that the risk did not shift. This circuitous approach ignores the express holdings of *Le Gierse* and *Carnation*. The majority then states that "The test continues to be whether, considering all of the facts, the risk of loss [has] shifted away from the taxpayer who seeks to deduct insurance premiums." The majority correctly states the test established in prior cases to be that an insurance relationship has not arisen if the risk has not shifted under the facts and circumstances. The majority then mystically espouses a factual pattern where the test cannot be met (p. 958):

> When petitioner sustains losses covered by its workers' compensation insurance, 92 percent is sustained by Lombardy. Accordingly, because petitioner, through its wholly owned Arizona corporation, owns all of Lombardy, it has not shifted the risk of sustaining such losses to unrelated parties in exchange for insurance premiums because the premiums were paid to the wholly owned subsidiary of its wholly owned subsidiary.

This explanation presents a completely new theory which has no roots in *Le Gierse* or *Carnation* and is without support in existing statute or case law. In essence, this new theory would disallow a deduction solely because of the ownership relationship between an insured and insurer. It assumes that

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[1] In order to find that petitioner was self-insuring, we would be required to either find some form of indemnification, as in *Carnation*, or offset, as in *Le Gierse*, or disregard Lombardy's separate corporate existence.

no risk can shift between related corporate entities. Although the majority expressly disclaims respondent's concept of "economic family" (see Rev. Rul. 77–316, 1977–2 C.B. 53), the theories are the same. The agreement to limit the application of the theory to insurance transactions does not cure its inherent deficiencies. There is no explanation as to the reason or principle that automatically precludes insurance between related entities. Additionally, the majority has stated, but not explained, how it is able to disregard the transactions in this case without crashing head on into the holding in *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943). Petitioner, in this case, has not elected to file a consolidated return and there is no reason to disregard the separate existence of Lombardy.

The only fact that the majority emphasizes as supporting a finding that the risk did not shift is that the sequence of executing the contracts reflects an interdependence of the agreements. I am not able to understand how that finding affects the quality of the contractual relationship or can be a basis for concluding that the risk did not shift. All mutual contractual obligations are by their very nature interdependent, and a party to a contract is not likely to be unilaterally bound or bound in a time sequence to his detriment.

The majority has found that no risk shifted and has also found the following facts which do not support such a finding: (1) There was no agreement or understanding that petitioner would indemnify Fremont or pay additional capital into Lombardy or would take any step to assure Lombardy's performance; (2) Lombardy was fully capitalized with $1 million of paid-up capital, an amount which exceeded the State of Colorado's statutory minimum requirement; (3) Lombardy was recognized, following an audit and certification, by the State of Colorado as an insurance company; (4) the States of California and Colorado either approved or established the rates of premiums for insurance and reinsurance between petitioner, Fremont, and Lombardy; and (5) Fremont (an unrelated California insurance company) remained primarily obligated to pay any workers' compensation claims against petitioner, if Lombardy failed, or was unable, to do so.

Under these and other facts stipulated by the parties, it is most difficult to understand how the risk did not shift from

petitioner to the insurer and reinsurer. To conclude that the risk did not shift because of petitioner's stock ownership or any shareholder control is without foundation and may require ignorance of a corporate existence. The facts in this case clearly show that petitioner no longer would bear the risk of loss and did not have direct control over the assets of Lombardy, especially those assets jointly held with the State of Colorado. It is important to note that Fremont would be obligated to pay any workers' compensation claims which Lombardy failed to pay.[2] Further, the majority appears unable to explain why risk does not shift in an insurance setting, when risk would shift with respect to all other business transactions between related taxpayers. Neither the majority nor the respondent has provided any persuasive arguments or compelling reasons to deny the possibility of an insurance relationship between related taxpaying entities.

How will courts apply the majority's rationale where: (1) The parent owns less than 100 percent of the captive; (2) the parent is the insurer rather than the insured; (3) less than all of the captive-subsidiary's insurance business is with the parent (cf. *Crawford Fitting Co. v. United States*, 606 Fed. Supp. 136 (N.D. Ohio 1985)); (4) the parent's claims paid by the subsidiary exceed the premiums paid by the parent; or (5) the insurance contract is between corporations related as brother-sister. One might boggle his imagination trying to determine whether the shareholders-insureds of a mutual insurance company could shift risk to their corporation.

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[2]Petitioner was required by statute to either self-insure or obtain insurance from a California authorized compensation carrier. Cal. Lab. Code sec. 3700 (West 1971). Petitioner's employees have a direct right of suit against Fremont. Cal. Lab. Code sec. 3753. In California, the employer may be relieved from any claim filed against it and the insurer is substituted in the employer's place. Cal. Lab. Code sec. 3755. Fremont, as the "insurer" under the laws of the State of California, was primarily liable for the payment of compensation of petitioner's employees. *Fireman's Fund Indemnity Co. v. State Industrial Accident Commission*, 39 Cal. 2d 831 (1952). Fremont remained primarily liable under California law, but was entitled to reinsure. To the extent the reinsurer became insolvent or unable to pay compensation claims, Fremont, not petitioner, was obligated to pay the claims. If both Fremont and Lombardy were unable to pay claims, the compensation claims would be paid from California's State Compensation Insurance Fund (Cal. Ins. Code secs. 11690 et seq., and 11770 et seq. (West 1972)), or from the California Insurance Guarantee Association (Cal. Ins. Code sec. 1063 (West 1972)), depending upon the circumstances. These special features of workers' compensation statutes make it especially clear that petitioner shifted the risk from itself and that petitioner's operating assets and capital would not be subject to claims for which premiums were paid to Fremont, whether or not the insurance coverage had been reinsured with Lombardy.

Although two District Courts have unquestioningly followed the respondent's and majority's theory, they leave the same questions unanswered and provide no better rationale than that offered by the majority. I respectfully dissent because the majority, in creating this new theory, has chosen to follow a path which is not in accord with precedent, and transcends established principles of law.

WILBUR, KÖRNER, SHIELDS, CLAPP, SWIFT, and WRIGHT, *JJ*, agree with this dissent.

DOROTHY VASTOLA, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 2247–84. Filed May 21, 1985.

Held: A royalty provision requiring petitioner to execute nonrecourse promissory notes payable solely out of coal production and secured only by mining rights under a coal sublease, as well as to pay cash and to execute a recourse promissory note, is not a "minimum royalty provision" within the meaning of sec. 1.612–3(b)(3), Income Tax Regs. Respondent's motion for partial summary judgment granted.

William J. Werner and *Richard L. Gold*, for the petitioner.
Francis J. Strapp, Jr., for the respondent.

OPINION

TANNENWALD, *Judge*: Respondent determined deficiencies in petitioner's Federal income taxes for taxable years 1977 and 1978 of $83,164.63 and $27,267.85, respectively. The case is before this Court on respondent's motion for partial summary judgment under Rule 121[1] on the issue of whether petitioner may deduct her claimed losses for the years in issue to the extent they resulted from alleged advanced minimum royalty payments.

At the time she filed her petition in this case, petitioner resided in Colts Neck, New Jersey. Petitioner filed Federal

[1]All Rule references are to the Rules of Practice and Procedure of this Court, and, unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

income tax returns, on which she elected the accrual method of tax accounting, for 1977 and 1978.

In her objection to respondent's motion, petitioner claims the following:[2] The Grand Coal Venture (GCV), a partnership electing under section 761(a)(2) to be excluded from the provisions of subchapter K, was formed during 1977 for the purpose of developing and mining certain coal-bearing property. Petitioner, based in large part upon a preliminary geologist's report attached to the GCV offering memorandum that estimated "probable minimum reserves" of 30-million tons of lignitic coal at a depth of less than 200 feet, decided to invest in GCV. On December 31, 1977, she executed a sublease agreement with Ground Production Corp. (the lessee of the property and petitioner's sublessor) for the right to mine coal, a subscription agreement with GCV for 7.2 units, a nonrecourse note in favor of Ground Production Corp., and a security agreement for the note. In relevant part, the sublease agreement provided as follows:

> Subject to the terms, provisions and conditions hereof and of the Lease, the Sublessor does hereby sublet unto the Sublessee the Percentage Interest in all of the coal contained in, on and underlying the tracts of land * * *, and the mining rights and privileges appurtenant thereto * * * for a period of [8] years[3] from the date hereof, provided however that the term of this Lease may be extended from year to year at the option of the Sublessee * * * until the Sublessee shall have mined and removed all merchantable coal from the Property.
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> . . . . . .
>
> Sublessee agrees that for each twelve month period during the term hereof (the "term" being the initial year period plus all extensions), but not to exceed a total of 20 years (although this Sublease may be further extended) commencing with the date hereof and ending one year thereafter (each such twelve month period is hereinafter referred to as a "term year"), it will pay to Sublessor a non-refundable minimum annual royalty of $40,000 (FORTY THOUSAND DOLLARS) (the "Minimum Annual Royalty") payable as hereinafter provided. * * *
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> At the closing the Sublessor requires payment of the Minimum Annual Royalty for the first year of the term of the Sublease in the amount of

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[2] We note that we view the facts and inferences to be drawn therefrom in the light most favorable to the party opposing the motion for summary judgment, i.e., petitioner. *Wright v. Commissioner*, 84 T.C. 636, 638 (1985). Moreover, respondent assumes, for purposes of his motion, that the transactions took place as described in the documents.

[3] We note that the copies of the sublease agreement submitted by each party as exhibits leave the number of years blank. However, the offering memorandum mentions 8-year subleases, and respondent, in the memorandum of law in support of his motion, characterizes the sublease as an "8 year lease."

$40,000.00 per Unit ($10,000.00 in cash and $30,000.00 by non-recourse Note per Unit) and in addition $10,000.00 per Unit (toward the second year's Minimum Annual Royalty) by the Sublessee's delivering his Recourse Promissory Note * * *

On or before December 31, 1978, the Sublessee shall execute and deliver his Non-Recourse Note for $30,000.00 per Unit and on or before December 31, 1979, and each year thereafter the Sublessee shall execute and deliver his Non-Recourse Promissory Note for $40,000.00 per Unit.

The Non-Recourse Promissory Notes will bear interest at the rate of 10% per annum or the maximum legal contract rate of interest, whichever is less, and shall be due and payable on December 31, 1997. The Promissory Notes will require payments of $2.00 per ton of coal mined, removed, shipped and sold to be applied first toward payment of accrued interest and the balance in reduction of principal.

* * * * * * *

Sublessor shall look solely to the security interest given by Sublessee to Sublessor in certain property and assets of the Sublessee, for the payment of the Minimum Annual Royalty Note [nonrecourse] * * * In no event shall the Sublessee be personally liable for the payment of the * * * Note * * * and in the event of any default hereunder or under the * * * Note no deficiency or other personal judgment will be rendered or entered against the Sublessee with respect to the obligations evidenced hereby or by the * * * Note.

The nonrecourse promissory notes executed by or for petitioner in 1977 and 1978 required monthly payments of $2 per ton of coal mined, removed, and shipped from the property, "provided, however, that in the event such monthly installments have not theretofore been sufficient to pay this Note in full, the unpaid principal balance of this Note and all unpaid and accrued interest shall be due and payable on December 1, 1997."[4] The notes each also provided that—

The holder of this Note shall look solely to the property and assets covered by the Security Agreement for the payment of this Note and the performance of the Participant's obligations hereunder and in no event shall the Participant be personally liable for the payment of the Note or the performance of the obligations hereunder. In the event of any default hereunder, no deficiency or other personal judgment shall be rendered or entered against the Participant with respect to the obligations evidenced by this Note.

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[4] There is no explanation given for the discrepancy in the due dates between the notes and the sublease agreement. The discrepancy is immaterial insofar as concerns our decision herein.

The security agreement grants to Ground Production Corp. a security interest in all coal lying under the property, petitioner's interest in all personal property thereon, and all accounts receivable, contract rights, and general intangible rights to the payment of money for coal, goods, and services that may become due to petitioner as a result of the mining, processing, and sale of coal from the property. A security interest in the proceeds from all of the above property was also given.

Petitioner paid $78,000 cash and executed a nonrecourse note for $216,000 (i.e., $30,000 × 7.2 units) in 1977, and executed a recourse note for $78,000 and a nonrecourse note for $216,000 in 1978.[5] No mineral product was produced or sold by petitioner or GCV during the years in issue.

Section 1.612–3(b)(3), Income Tax Regs., sets forth the rules for deductibility of advanced royalties. Generally, advanced royalty payments are deductible only in "the year the mineral product, in respect of which the advanced royalties were paid or accrued, is sold." Sec. 1.612–3(b)(3), Income Tax Regs. When the advanced royalty is paid or accrued "as a result of a minimum royalty provision,"[6] however, the rule is different—

in the case of advanced mineral royalties paid or accrued in connection with mineral property *as a result of a minimum royalty provision*, the payor, at his option, may instead *treat the advanced royalties as deductions from gross income for the year in which the advanced royalties are paid or accrued.* See section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For purposes of this paragraph, a minimum royalty provision requires that a substantially uniform amount of royalties be paid at least annually either over the life of the lease or for a period of at least 20 years, in the absence of mineral production requiring payment of aggregate royalties in a greater amount. For purposes of the preceding sentence, in the case of a lease which is subject to renewal or extension, the period for which it can be renewed or extended shall be treated as part of the term of the original lease. * * * The provisions of this subparagraph do not allow as deductions from gross income amounts disallowed as deductions under other provisions of the Code, such as section 461 (relating to general rule for

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[5] We note that petitioner would appear to be obligated under the sublease agreement only to pay $72,000 cash in 1977 and to execute a $72,000 recourse note in 1978 (i.e., $10,000 × 7.2 units). Petitioner's moving papers allege, in a footnote, that the note should have been in the amount of $210,000, and that, in any event, petitioner claimed only $288,000, and not the full $294,000 "paid," as a deductible royalty expense in each of the years in issue.

[6] For a discussion of the economics of minimum royalty provisions, see *Wing v. Commissioner*, 61 T.C. 17, 38 n. 30 (1963).

taxable year of deduction) * * * [Sec. 1.612–3(b)(3), Income Tax Regs.; emphasis added.]

Initially, petitioner argues that, irrespective of the impact of section 1.612–3(b)(3), Income Tax Regs., *supra*, there is a question of fact that the Court must resolve, namely, the value of the coal sublease securing payment of the nonrecourse notes. Petitioner's contention was considered and rejected in *Wing v. Commissioner*, 81 T.C. 17, 40–41 (1983), wherein we specifically ruled that the fact that the securing property might have had sufficient value to assure the ultimate payment of nonrecourse promissory notes was irrelevant to the determination of the applicability of the aforementioned regulation. See also *Maddrix v. Commissioner*, 83 T.C. 613, 623 (1984), on appeal (11th Cir., Mar. 12, 1985). We continue to adhere to that position.

Petitioner next contends that the requirement under the sublease agreement that nonrecourse notes be executed in the amounts of $30,000 per unit for the first 2 years and $40,000 per unit per year thereafter for the remainder of the sublease term satisfies the regulation, in that the royalty provision requires yearly accruals of royalties. Respondent argues that because the nonrecourse notes are payable solely out of the proceeds of coal production, the sublease agreement does not *require* a substantially uniform annual royalty, and thus does not contain a "minimum royalty provision," within the meaning of the regulation. Thus, respondent argues that, as a matter of law, petitioner may deduct royalties only to the extent that coal was sold during the years in issue. For the reasons hereinafter stated, we agree with respondent.

The interpretation of section 1.612–3(b)(3), Income Tax Regs., *supra*, has been before this Court on two recent occasions. In *Wing v. Commissioner, supra*, after upholding the validity of the regulation, we held that an agreement providing for "an advance minimum Annual Royalty of $60,000 ($6,000 for each of the first ten years of the sublease)" to be "paid with $10,000 cash upon execution of this sublease and the delivery of the Lessee's nonrecourse promissory note of $50,000" did not contain a minimum royalty provision, within the meaning of section 1.612–3(b)(3), Income Tax Regs., *supra*. We reasoned that the agreement did not *require* annual payments over the lease period, as periodic payments under

the note were contingent upon the production of coal, and the only payments actually required, if indeed there were any, were *eventual* payments. *Wing v. Commissioner, supra* at 40. The "clear meaning of the regulation," we noted, "is to allow current deductions for advance minimum royalties that are required to be paid regardless of production." *Wing v. Commissioner, supra* at 41–42.

More recently, in *Maddrix v. Commissioner, supra*, a case strikingly similar to the instant case, we held that "The contingent nature of the note is inherently inconsistent with the regulatory definition of a minimum royalty provision." 83 T.C. at 623. In *Maddrix*, the sublease agreement provided for an "annual minimum royalty" in the amount of $300,000 for each year of the 10-year sublease period, $590,000 to be paid in cash at execution together with an aggregate of $1,950,000 in nonrecourse notes, bearing interest at 6 percent per annum, and payable in equal quarterly installments of $81,196. Despite the stated quarterly payment schedule, the terms of the notes and of the sublease agreement, along with the offering memoranda, provided that the notes were payable out of coal sale proceeds, that the notes were nonrecourse, and that the holder's sole remedy in the event of default was to proceed against the taxpayer's interest in the venture. Further, the sublease had a initial term of 10 years, and the taxpayer's nonrecourse note came due in some 7¾ years. Noting that our opinion in *Wing* stands for the proposition that eventual payment does not establish the existence of an annual *requirement* of payment, we held as a matter of law, *on respondent's motion for partial summary judgment*, that the taxpayer's nonrecourse note, on which payments were contingent on production, represented an obligation so illusory as not to evince "an enforceable *requirement* that substantially uniform minimum royalties be paid annually in any event, regardless of annual production." *Maddrix v. Commissioner, supra* at 623; emphasis in original.

In the instant case, petitioner is obligated annually to "pay to Sublessor a non-refundable minimum annual royalty of $40,000" per unit, "payable as hereinafter provided," until the earlier of the termination date of the sublease and December 31, 1997. However, as in *Wing* and *Maddrix*, the substance of the entire transaction undoes what appears at first glance to

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be a uniform annual requirement. According to the documents, petitioner's "payments" are for the most part to consist of nonrecourse notes, which are payable in monthly amounts calculated per ton of coal shipped; the note balances not paid in this way come due on December 1, 1997—some 20 years after the date of execution of the notes in question. In the event of default, the holder's sole recourse is against the securing property, i.e., petitioner's interest in the coal and its proceeds. The sublease agreement runs through 1985, but is renewable, if petitioner so chooses, from year to year until all the merchantable coal is removed.

Petitioner contends that *Wing v. Commissioner, supra*, is distinguishable on two grounds, arguing that the royalty provision in *Wing* did not require the execution of separate, annual promissory notes and that the primary lease term in *Wing* expired before the single note came due. We disagree, and find *Wing* (and *Maddrix* as well)[7] materially indistinguishable from the instant case. While petitioner herein was required under the provision to execute a separate nonrecourse note in each of the years in issue, this difference does not provide a valid basis for distinguishing *Wing* and *Maddrix*. In substance, the payment schedule on the notes in all three cases was the same—periodic payments as coal was shipped, and eventual payment of the balance; none of the royalty provisions *required* that a substantially uniform amount of royalties be paid at least annually. Petitioner's argument concerning the sublease term is that because the term of the sublease interest securing the notes in the instant case extends beyond the due date of the notes in issue, the notes herein are not illusory. While the lease term in *Wing* indeed expired before the note came due, this fact was not the basis of our decision therein. See 81 T.C. at 39 n. 32. Moreover, despite the fact that the note in *Maddrix* was payable *before* the end of the sublease term, we found the note illusory as a matter of law for purposes of the regulation. In short, a nonrecourse note on which the only periodic payments are contingent on production is, under the interpretation of section 1.612–3(b)(3),

[7] Neither party brought *Maddrix v. Commissioner*, 83 T.C. 613 (1984), on appeal (11th Cir., Mar. 12, 1985), to the Court's attention, although the opinion was published on Oct. 22, 1984, respondent's motion was not filed until Dec. 20, 1984, and petitioner's response to said motion was filed on Feb. 14, 1985.

Income Tax Regs., *supra*, in *Wing* and *Maddrix*, too illusory to satisfy the provision in the regulation that the agreement of the parties *require* annual uniform payments over the life of the lease, and this result is irrespective of the fact that, with or without renewals,[8] the securing lease interest will still be in effect when the notes eventually become due.

However, petitioner raises a legal issue not discussed in *Wing* or *Maddrix*, i.e., that the express, repeated reference in section 1.612–3(b)(3), Income Tax Regs., *supra*, to "royalties paid or accrued" does not permit an interpretation requiring actual, annual payments by accrual-method taxpayers such as petitioner. According to petitioner, in order to decide whether the nonrecourse notes justified proper *accruals* of royalty obligations during the years in issue, we must hold a trial on the question of the value of the underlying coal sublease given as collateral for the notes, and thus deny respondent's motion.

On one hand, the language of the regulation allows a deduction for advanced royalties *paid or accrued* as a result of a minimum royalty provision "in the year in which the royalties were *paid or accrued*"; on the other hand, it defines a minimum royalty provision as one that "requires that a substantially uniform amount of royalties *be paid* at least annually." Sec. 1.612–3(b)(3), Income Tax Regs., *supra*; emphasis added. A strong argument can be made that the "be paid at least annually" language must, in order not to render the "paid or accrued" language mere surplusage, be interpreted to include a royalty provision that requires an *accrual* of royalty obligations at least annually. See Falik, "When Will Minimum Annual Royalties Be Deductible by Accrual-method Taxpayers?" 61 J. Tax. 42, 44–46 (1984); see also Rev. Rul. 77–489, 1977–2 C.B. 177, and Rev. Rul. 80–70, 1980–1 C.B. 104 (involving recourse obligations). However, we need not deal with this argument in the instant case, because, under the rules of section 461, to which section 1.612–3(b)(3), Income Tax Regs., *supra*, is expressly subject, petitioner may not properly accrue the liability under the notes in question during the years in issue.

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[8] Petitioner treats the sublease term as extending for 20 years from Dec. 31, 1977, on the basis that the initial 8-year term could, at her option, be extended until Dec. 31, 1997. Assuming, but not deciding, that petitioner's treatment is correct, it can do no more than to put her in the same position with regard to the sublease term as the taxpayer in *Maddrix v. Commissioner*, *supra*.

Section 461(a) provides that the taxpayer's method of tax accounting determines the taxable year for which deductions are proper. Under section 446(c)(2), accrual is a proper tax accounting method. It is well established that the proper year of deduction for an accrual-method taxpayer is "the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy." Sec. 1.461–1(a)(2), Income Tax Regs.; see *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 543 (1979); *Burlington Northern Railroad Co. v. Commissioner* 82 T.C. 143, 146–147 (1984); see also Pub. L. 98–369, sec. 91(a), 98 Stat. 598–600 (1984) (adding Code section 461(h)(4), effective as to deductions allowable after July 18, 1984). It is also well established that contingent liabilities may not be accrued and deducted while they are still contingent. *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281, 284 (1944); *Bennett Paper Corp. v. Commissioner*, 78 T.C. 458, 470 (1982), affd. 699 F.2d 450 (8th Cir. 1983).

Just as nonrecourse notes upon which payment is wholly contingent on production are so illusory as to be "inherently inconsistent with the regulatory definition of a minimum royalty provision" (*Maddrix v. Commissioner, supra* at 623), such notes are also so illusory as to fail to establish all the events necessary to determine the fact of liability. *Brountas v. Commissioner*, 692 F.2d 152, 161 (1st Cir. 1982), and *CRC Corp. v. Commissioner*, 693 F.2d 281, 283 (3d Cir. 1982), vacating and remanding on other grounds[9] 73 T.C. 491 (1979); *Gibson Products Co. v. United States*, 637 F.2d 1041, 1047-1049 (5th Cir. 1981). In the words of the Court of Appeals for the Fifth Circuit, a "true lending transaction," and thus a true liability, requires " 'a reasonable basis for the prediction that the ability of the borrower to repay will not be wholly or substantially contingent upon the success or failure of the business venture.' " *Gibson Products Co. v. United States, supra* at 1047; citation omitted.

In the instant case, the facts put forth by petitioner reveal that repayment of the notes in question is, at least until December 1, 1997, wholly contingent on production. Thus,

[9]For an explanation of the relationship between the First and Third Circuits' holdings on the accrual issue and this Court's opinion in *Brountas v. Commissioner*, 73 T.C. 491 (1979), see *Saviano v. Commissioner*, 80 T.C. 955, 963 n. 9 (1983).

petitioner's only possible argument, under the broad interpretation of section 1.612–3(b)(3), Income Tax Regs., *supra*, discussed above, is that because the value of the securing coal sublease will, on December 1, 1997, be sufficient to assure that petitioner will repay the note obligations, the notes are not *wholly* contingent and all the events necessary to establish the fact of liability occurred upon execution of each of the notes in question. According to this line of argument, petitioner should at least be given the opportunity at trial to prove the present and eventual values of the coal sublease. We disagree.

While there may be situations in which taxpayers may properly accrue liabilities under nonrecourse notes (a question we need not address), the instant case is not one of those situations. The property securing petitioner's notes was nothing more than the right to mine coal from the subject land for a limited period of time, and the right to any proceeds therefrom. Unlike other types of property, this property by definition had absolutely no value apart from the anticipated stream of income from the production of coal. Thus, the value of the property securing eventual payment of the notes was no less contingent on production than was the periodic payment obligation. Consequently, petitioner's nonrecourse note obligations were *wholly* contingent on production. See *Brountas v. Commissioner*, *supra* at 161–162; cf. *Estate of Baron v. Commissioner*, 83 T.C. 542, 550–552 (1984), on appeal (2d Cir., Mar. 26, 1985). Under these circumstances, expert testimony estimating the present and/or eventual values of the coal sublease would serve no purpose. The prospect of repayment of the notes in question in 1997, particularly in light of the fact that there was no production in 1977 and 1978, is simply too speculative and contingent to justify accrual of the liabilities, irrespective of the present or possible future value of the sublease. See *Brountas v. Commissioner*, *supra* at 161–162; *Gibson Products Co. v. United States*, *supra* at 1047–1049; *CRC Corp. v. Commissioner*, *supra* at 283.[10]

[10] We note that this conclusion is further supported by the cases denying the inclusion of contingent nonrecourse liabilities in the cost basis of property acquired. See, e.g., *Brountas v. Commissioner*, 692 F.2d 132, 157–158 (1st Cir. 1982), vacating and remanding on other grounds 73 T.C. 491 (1979); *Denver & Rio Grande Western R.R. Co. v. United States*, 205 Ct. Cl. 597, 505 F.2d 1266 (1974); *Estate of Baron v. Commissioner*, 83 T.C. 542, 549–553 (1984), on appeal (2d Cir., Mar. 26, 1985). A taxpayer claiming a current deduction has no better claim than one seeking an increased cost basis.

We hold, as a matter of law, that all the events necessary to establish liability on the notes in question did not occur during the years in issue, and that accruals of the royalty obligations would therefore be improper. See ABKCO Industries, Inc. v. Commissioner, 482 F.2d 150, 154 (3d Cir. 1973). Under such circumstances, and absent any indication by petitioner that there are any other disputed facts, summary adjudication is appropriate. See *Gauntt v. Commissioner*, 82 T.C. 96, 105 (1984), on appeal (9th Cir., Dec. 10, 1984); cf. *Maddrix v. Commissioner, supra*; *Graf v. Commissioner*, 80 T.C. 944 (1983); *Saviano v. Commissioner*, 80 T.C. 955 (1983).

Thus, even if the definition of "minimum royalty provision" under section 1.612–3(b)(3), Income Tax Regs., *supra*, were to be interpreted to include royalty provisions requiring the execution of promissory notes for which annual accruals of liability would be proper, the royalty provision in the instant case would not be a minimum royalty provision. Regardless of the value of the underlying coal sublease, then, petitioner's deductions under the royalty provision were improper, and respondent's motion must be granted.

An appropriate order will be entered.

"The only difference lies in the nature of the expense, generally speaking, whether the expense creates an asset with a useful life greater than 1 year. Thus, those cases which do not recognize a note or an obligation for purposes of computing the basis of an asset are equally applicable when the taxpayer is claiming a current expense. An expenditure funded with the proceeds of a contingent obligation represents neither a payment by, or cost to, a taxpayer for tax purposes. [*Graf v. Commissioner*, 80 T.C. 944, 949 (1983); fn. ref. omitted.]"

We reject petitioner's argument that the Supreme Court's opinion in *Commissioner v. Tufts*, 461 U.S. 300 (1983), requires recognition of nonrecourse debt for purposes of accrual. The Court's holding in *Tufts* that a transfer of property encumbered by a nonrecourse liability results in realization of income to the extent of the liability does not require that nonrecourse debt not be considered illusory in other contexts. See *Odend'hal v. Commissioner*, 748 F.2d 908, 913 (4th Cir. 1984), affg. 80 T.C. 588 (1983); *Graf v. Commissioner, supra* at 952–953. The *Tufts* case does not alter our analysis regarding accrual of liabilities in the instant case.

RICHARD GAJEWSKI, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 22936–80. Filed May 23, 1985.

Held, on remand from the Court of Appeals for the Second Circuit (723 F.2d 1062), that this petitioner's gambling activities do not constitute a trade or business. *Held, further*, that the failure of Congress to permit the deduction of his gambling losses for purposes of computing the minimum tax is not unconstitutional.

John W. Shea, for the petitioner.

Powell W. Holly, Jr., and *Robert E. Marum*, for the respondent.

OPINION

TANNENWALD, *Judge*: This case is before us upon the reversal and remand of our decision (T.C. Memo. 1983–133) by the United States Court of Appeals for the Second Circuit (723 F.2d 1062 (2d Cir. 1983)). In our decision, we held that petitioner's gambling losses during the taxable years 1976 and 1977 were deductible as trade or business expenses under section 62(1),[1] and were therefore not tax-preference items for minimum tax purposes. In so holding, we applied the "facts and circumstances test" for determining whether petitioner was in a trade or business, a test we adopted in our Court-reviewed opinion in *Ditunno v. Commissioner*, 80 T.C. 362 (1983), overruling our prior decision in *Gentile v. Commissioner*, 65 T.C. 1 (1975), which had adopted as the test for determining whether a taxpayer was engaged in a trade or business the holding of one's self out by offering goods or services. In reversing our prior decision herein, the Second Circuit rejected the *Ditunno* test and adopted the *Gentile* test. It then "remand[ed] the case for further proceedings in accordance with this opinion." 723 F.2d at 1067.

Petitioner, stating that the instant case is before us "on its own merits," first urges that we follow our decision in *Groetzinger v. Commissioner*, 82 T.C. 793, 803 (1984), which reaffirmed the position we had taken in *Ditunno* and reiterat-

[1] Unless otherwise indicated, all references are to the Internal Revenue Code of 1954 as amended and in effect during the taxable years at issue.

ed the "facts and circumstances test" based upon such considerations as the frequency, extent, and regularity of the activity in question.[2] Petitioner clearly cannot prevail on this basis. The Court of Appeals for the Second Circuit did not remand the instant case for consideration "on the merits." Rather, it remanded for further proceedings in accordance with its opinion, which clearly stated: "In our view the earlier-established 'goods and services' requirement rather than the 'facts and circumstances' approach is the appropriate *minimum standard* * * * for determining whether a taxpayer is engaged in 'trade or business.'" 723 F.2d at 1066; emphasis added. Since petitioner clearly does not satisfy the *minimum standard* (indeed he makes no argument that he does), we have no choice but to hold that he is not engaged in a trade or business so as to qualify for the deduction of his gambling losses in computing adjusted gross income for purposes of the minimum tax.[3]

Petitioner next argues that the 16th Amendment requires that we net his gambling losses against his gains in order to determine whether he has income which Congress can constitutionally tax, under the principles articulated in *Eisner v. Macomber*, 252 U.S. 189 (1920).[4] We reject this contention. To understand our reasons for doing so requires a recital of some legislative and judicial history. Prior to 1934, when there was no specific provision governing the deductibility of gambling losses, the Board of Tax Appeals adopted a "netting" approach.

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[2] We also followed *Ditunno* in *Meredith v. Commissioner*, T.C. Memo. 1984-651; *Wells v. Commissioner*, T.C. Memo. 1984-507; *Stein v. Commissioner*, T.C. Memo. 1984-403, on appeal (3d Cir., Oct. 26, 1984); *Cull v. Commissioner*, T.C. Memo. 1983-80, revd. 746 F.2d 1148 (6th Cir. 1984), petition for cert. filed Jan. 2, 1985; and *Nipper v. Commissioner*, T.C. Memo. 1983-644, affd. by court order 746 F.2d 813 (11th Cir. 1984).

[3] We so conclude, not on the basis of respondent's argument that we are required to do so by *Golsen v. Commissioner*, 54 T.C. 742 (1970), affd. on the substantive issue 445 F.2d 985 (10th Cir. 1971), but on the basis of the mandate of the Court of Appeals *in this case*. *Golsen* specifies only the circumstances under which we will follow a decision *in another case* by the particular Court of Appeals involved.

[4] In his brief in the prior proceeding herein, petitioner raised additional constitutional arguments based upon alleged discrimination in light of the treatment accorded other gamblers. Because of our prior holding in petitioner's favor, we did not previously consider these arguments or the one advanced herein. Nor did petitioner ask the Second Circuit to consider these grounds as alternative arguments in support of his defense against respondent's appeal. Petitioner has now abandoned the arguments based upon alleged discrimination which, in any event, we believe were without merit (see *High Plains Agricultural Credit Corp. v. Commissioner*, 63 T.C. 118, 127 (1974)), and has confined his constitutional contention as stated in the body of this opinion. We believe that, in view of the fact that the Second Circuit did not consider this argument, it is appropriate for us to do so on this remand.

Thus, in *McKenna v. Commissioner*, 1 B.T.A. 326 (1925), a professional gambler's, i.e., bookmaker's, *gross income*, as defined by section 213(a) of the Revenue Act of 1918, 40 Stat. 1058, was limited to the aggregate of his receipts less disbursements to bettors, or his "actual" gain. The Board extended this netting approach to the casual gambler's gross income calculation in *Frey v. Commissioner*, 1 B.T.A. 338 (1925).[5]

In 1934, Congress enacted the provision that later became the present section 165(d): "Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions." Since that time, the courts, with the exception of the Court of Appeals for the First Circuit in *Winkler v. United States*, 230 F.2d 766 (1st Cir. 1956), have consistently rejected the "netting" approach, and instead have included gambling winnings in gross income and treated gambling losses as itemized deductions, subject to the statutory limitation that such losses could not exceed such winnings. E.g., *McClanahan v. United States*, 292 F.2d 630, 631–632 (5th Cir. 1961); *Johnston v. Commissioner*, 25 T.C. 106, 108 (1955).[6]

The impact of the 1934 statutory change was specifically addressed by the Court of Appeals for the First Circuit in *Winkler v. United States, supra*. In that case, that court expressed the view that, under the statute, a "casual" gambler's losses could no longer be deducted in determining gross income; they could, however, be deducted, up to the amount of gambling winnings, *from* adjusted gross income in determining taxable income. As to the "professional" gambler, the Court of Appeals continued, "Congress lacked the power to undo the *McKenna* rule by statutory change. Losses up to the amount of gambling winnings continue to be a reduction of the amount to be reported as gross income by the professional gambler." *Winkler v. United States, supra* at 775–776.

The *Winkler* dichotomy, which seemingly throws the blanket of constitutional protection over the "professional gam-

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[5] Although *McKenna* did not directly place the "netting" approach on a constitutional foundation, there are inferences to that effect in the opinion. *Frey* made no reference to constitutional considerations. It appears that the "netting" approach was developed to avoid the potential discrimination in treatment of taxpayers engaged in gambling activities arising out of the fact that such activities were illegal in some States and not in others, and out of the judicial position that deductions for illegal expenditures should not be allowed.

[6] See also *Heidelberg v. Commissioner*, T.C. Memo. 1977–133; *Carter v. Commissioner*, T.C. Memo. 1976–33.

bler,"[7] but not the "casual gambler," and the fallout, if any, from *McKenna v. Commissioner, supra*, and *Frey v. Commissioner, supra*, provide the focus for our further line of inquiry herein. If petitioner is a "casual gambler," it seems clear that, except for the possible impact of *Frey*, his position herein should be rejected. On the other hand, if he is a "professional gambler," the "netting" approach that petitioner espouses may be required by virtue of the constitutional limitations suggested by the Court of Appeals in *Winkler*.

Several cases have loosely used the term "professional gambler" to include persons who gamble on a regular, "full-time" basis. See, e.g., *Stein v. Commissioner*, 322 F.2d 78, 79 (5th Cir. 1963), affg. a Memorandum Opinion of this Court; *Green v. Commissioner*, 66 T.C. 538, 545 (1976); *Bickers v. Commissioner*, T.C. Memo. 1960–83. In its opinion in *Winkler*, the Court of Appeals did not define the term, but it seems clear from an examination of the opinion that the Court of Appeals had in mind a gambler whose activities, unlike those of a "casual gambler," involved an ongoing commitment to losses which he hoped would be exceeded by his winnings. See 230 F.2d at 769.[8] Moreover, since *Winkler* dealt with a bookmaker who had customers, it seems clear that the Court of Appeals did not intend a "professional gambler" to be a person who

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[7] The precise scope of the decision in *Winkler* may well be far narrower than some of its language would suggest. Thus, the First Circuit, at the very end of its opinion, seems to confine its constitutional protection to the requirement that a professional gambler must be entitled to offset "his winnings on each race with his losses *in that same race*" before he has income which can be constitutionally taxed. See 230 F.2d at 776; emphasis added.

[8] The court later discussed "two very real distinctions between the activities of the professional and the casual gambler"—

"First, the casual gambler has no inevitable losses * * * representing the cost of goods raffled off in a lottery. Conceivably the casual gambler might never sustain a "loss" of any kind whatsoever.

"Moreover the casual gambler ordinarily does not view his transactions as a yearly operation. That is to say, even if he should sustain losses he views them as isolated incidents unrelated to his winnings, not intending to exploit the laws of probability in such a way as to emerge with a favorable balance over an extended period of operations. Since the casual gambler views his bets individually as isolated incidents, there seems no good reason why the taxing authority should not do likewise. The professional, by way of contrast, founds his business directly upon the operation of the laws of probability over an extended period of time. When the taxing authority chooses to view his business as a series of unrelated individual transactions it does violence to the truth and arbitrarily deprives him of the benefit of the laws of probability upon which his enterprise is necessarily founded and without which it cannot succeed over any substantial period. [*Winkler v. United States*, 230 F.2d 766, 774 (1st Cir. 1956).]"

Petitioner, in his brief in the prior proceeding herein, asserted that he was a "system bettor." Although we doubt that the *Winkler* court intended its rationale to apply to such a situation, we need not and do not face the issue, since there is no evidence as to whether such a bettor would have the requisite commitment.

gambled for his or her own account, even if such activities were continuous over an extended period. The concept that having (or soliciting) customers is a prerequisite to being a "professional gambler" is implicit in the cost-of-goods analogy upon which the opinion in *Winkler* relied. See 230 F.2d at 769–770. In the instant case, the record simply does not permit us to find that petitioner, whose activities did not involve either the inevitable commitment to losses or the dealing with customers, was a "professional gambler." On the contrary, the foregoing analysis leads inevitably to the conclusion that petitioner was a "casual gambler." Such being the case, he does not come under the blanket of constitutional protection suggested by *Winkler*.

The power of Congress to tax income is extremely broad, and has been held to include the power to tax gross receipts. *Penn Mutual Indemnity Co. v. Commissioner* 277 F.2d 16, (3d Cir. 1960), affg. 32 T.C. 653 (1959); *Waller v. Commissioner*, 39 T.C. 665, 679 (1963).[9] Moreover, the present definition of gross income in section 61(a) was designed to permit Congress to exert "the full measure of its taxing power." *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429 (1955); *Helvering v. Clifford*, 309 U.S. 331, 334 (1940). We see no need to indulge in a lengthy analysis of the foundations of that power; the breadth of article I, section 8, clause 1, of the Constitution and the interplay between it and the 16th Amendment are discussed in depth in the opinion of this Court in *Penn Mutual Indemnity Corp. v. Commissioner, supra*. We leave for another day the question of whether we will continue to apply the rationale of *McKenna v. Commissioner, supra*, and *Winkler v. Commissioner, supra*, to the professional gambler who meets the tests articulated by those cases, both of which, we again note, involved bookmakers. As far as *Frey v. Commissioner, supra*, is concerned, we think that subsequent legislative and judicial history has sapped it of its vitality. See *Barba v. United States*, 2 Cl. Ct. 674, 680–681 (1983), and cases cited thereat; cf. *Hicks v. Commissioner*, 47 T.C. 71, 74 (1966).

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[9] Not having been a professional gambler, petitioner could not claim that his gambling losses were a cost of goods sold, and thus not a legitimately taxable component of gross income. See *Sullenger v. Commissioner*, 11 T.C. 1076, 1077 (1948); see also *Fedone v. United States*, 151 F. Supp. 288 (Ct. Cl. 1957); 1 J. Mertens, Law of Federal Income Taxation, secs. 4.07, 5.10 (1961).

Concededly, the application of the minimum tax to petitioner appears harsh, but given the mandate of the Second Circuit and our inability to discern any constitutional infirmity, we have no choice but to hold that petitioner is subject to the alternative minimum tax.[10]

As to the revised deficiencies and revised additions to tax,

Decision will be entered for the respondent.

WILLIAM J. LAW AND HELEN M. LAW, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 17315–82, 10054–83. Filed May 23, 1985.

P was a partner in a limited partnership organized to acquire and distribute a motion picture film. In the notice of deficiency and by amendment to his answer, the Commissioner has disallowed all of the loss claimed by P as his distributive share of the partnership's net loss, on the grounds, among others, that the partnership did not acquire a depreciable interest in the film, that the partnership's depreciable basis in the film was overvalued, that the loss, if allowable, was limited to the amount to which P was "at risk," and that the partnership's activities were not engaged in for profit. After trial, and after the Commissioner had submitted the opening brief and Ps had submitted a brief in answer, the Commissioner moved for leave to amend his answer a second time to assert the applicability of sec. 6621(d), I.R.C. 1954, as added by the Tax Reform Act of 1984, which imposes a higher rate of interest on substantial underpayments attributable to certain tax motivated transactions. *Held*, the Commissioner's motion is denied because the proposed amendment, while not requiring a further trial, would unfairly prejudice Ps.

Rex A. Guest, for the petitioners.
David D. Baier, for the respondent.

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[10] We note that Congress, in a 1982 amendment to the minimum tax provisions, provided without comment that, in determining "alternative minimum taxable income," adjusted gross income is to be reduced by wagering losses allowable under sec. 165(d). Pub. L. 97–248, sec. 201(a), 96 Stat. 411 (1982); H. Rept. 97–760 (Conf.) (1982), 1982–2 C.B. 600, 603. Such amendment was prospective only. Pub. L. 97–248, *supra* at sec. 201(d)(1). Had Congress intended this change to apply to taxpayers in petitioner's position it would have either effected it earlier or made the amendment retroactive. See *Buttke v. Commissioner*, 72 T.C. 677, 680–681 (1979), affd. per curiam 625 F.2d 202 (8th Cir. 1980).

OPINION

SIMPSON, *Judge*: On March 28, 1985, the Commissioner filed a "Motion for Leave to File Second Amendment to Answer," pursuant to Rule 41(a) of the Tax Court Rules of Practice and Procedure.[1] He seeks leave to amend his answer to assert the applicability of section 6621(d), I.R.C. 1954,[2] as added by section 144 of the Tax Reform Act of 1984, Pub. L. 98–369, 98 Stat. 682, which increased the rate of interest on substantial underpayments attributable to certain tax motivated transactions. The petitioners, William J. and Helen M. Law, have filed a "Notice of Objection" to the Commissioner's motion.

The trial of this case was held on July 9 through July 12, 1984, and involved deficiencies determined to be owing by the petitioners for 1978 and 1979. The Commissioner filed the opening brief (because he bears the burden of proof on several issues) on October 10, 1984, and the petitioners filed their brief in answer on March 18, 1985. The Commissioner has not yet filed his reply brief.

Mr. Law became a partner in 1978 of an Illinois limited partnership (the partnership) organized to acquire and to distribute a motion picture film (the film). On their joint Federal income tax returns for 1978 and 1979, the petitioners claimed a distributive share of the partnership's net loss for those years. In the notice of deficiency and by a prior amendment to his answer, the Commissioner has disallowed all of the claimed distributive shares of the losses on numerous and alternative grounds, including: (1) The partnership is not entitled to the film depreciation deductions claimed on its partnership returns because it did not acquire a depreciable interest in the film; (2) if the partnership acquired a depreciable interest in the film, it is entitled to depreciation deductions smaller than those claimed because a nonrecourse debt included in the film's depreciable basis was too contingent to be a genuine indebtedness, because the face amount of the nonrecourse debt exceeded the fair market value of the interest acquired in the film, and because the partnership was required to use the income forecast rather than the double-declining

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[1] Any reference to a Rule is to the Tax Court Rules of Practice and Procedure.

[2] Any statutory reference is to the Internal Revenue Code of 1954 as in effect during the years in issue, unless otherwise indicated.

balance method of depreciation; (3) the partnership's activities were not "engaged in for profit" within the meaning of section 183; and (4) the amount of Mr. Law's deductible share of the partnership losses is limited by section 465(a) to the amount for which he was "at risk."

Section 6621(d) provides for an increase in the interest rate due on underpayments where there is a "substantial underpayment" (an underpayment exceeding $1,000) in any taxable year "attributable to 1 or more tax motivated transactions." Sec. 6621(d)(1) and (2). A "tax motivated transaction" is defined as:

> (i) any valuation overstatement (within the meaning of section 6659(c)),
> (ii) any loss disallowed by reason of section 465(a) and any credit disallowed under section 46(c)(8),
> (iii) any straddle (as defined in section 1092(c) without regard to subsections (d) and (e) of section 1092), and
> (iv) any use of an accounting method specified in regulations prescribed by the Secretary as a use which may result in a substantial distortion of income for any period.
> [Sec. 6621(d)(3)(A)]

In addition, section 6621(d)(3)(B) provides that "The Secretary may by regulations specify other types of transactions which will be treated as tax motivated * * * and may by regulations provide that specified transactions being treated as tax motivated will no longer be so treated."

The Secretary has promulgated temporary regulations under the regulatory authority granted in subparagraphs (A)(iv) and (B). Sec. 301.6621-2T, Proced. & Admin. Regs. (Temporary). The temporary regulations list several circumstances (not relevant to the case before us) in which the disallowance of a deduction or credit shall be treated as attributable to the use of an accounting method that may result in a substantial distortion of income and, thus, shall be a tax motivated transaction.[3] The regulations also specify, pursuant to section

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[3] Q-3 and A-3 of sec. 301.6621-2T, Proced. & Admin. Regs. (Temporary), 49 Fed. Reg. 50391-50394 (Dec. 28, 1984), provide that a deduction or credit disallowed, or income included, in any of the following circumstances shall be treated as attributable to the use of an accounting method that may result in a substantial distortion of income:

(1) Any deduction disallowed for any period by reason of section 464 or section 278(b), relating to certain expenses of farming syndicates;

(2) In the case of a taxpayer who computes taxable income using the cash receipts and disbursements method of accounting, any interest deduction disallowed for any period by reason of

6621(d)(3)(B), two additional types of transactions which will be treated as tax motivated transactions: first, "Any deduction disallowed for any period under section 183, relating to an activity engaged in by an individual or an S corporation that is not engaged in for profit," and second, "Any deduction disallowed for any period under section 165(c)(2), relating to any transaction not entered into for profit." Sec. 301.6621-2T, Q-4 and A-4, Proced. & Admin. Regs. (Temporary), 49 Fed. Reg. 50391-50394 (Dec. 28, 1984). Both section 6621(d) and the temporary regulations apply to interest accruing after December 31, 1984, on a substantial underpayment attributable to tax motivated transactions, regardless of the date prescribed for payment of the tax. Sec. 301.6621-2T, Q-10 and A-10, Proced. & Admin. Regs. (Temporary). The Tax Court has jurisdiction to determine the portion (if any) of a deficiency which is a substantial underpayment attributable to tax motivated transactions. Sec. 6621(d)(4).

In his motion to amend his answer, the Commissioner seeks to invoke the applicability of section 6621(d) on the grounds that the petitioners are liable for substantial underpayments in 1978 and 1979 attributable to a "valuation overstatement"

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section 461(g), relating to prepaid interest, provided the interest is not paid with respect to indebtedness incurred in connection with (i) the purchase, refinancing, or improvement of the principal residence of the taxpayer, or (ii) the purchase of consumer goods by the taxpayer;

(3) Any interest deduction disallowed for any period because the amount of the claimed deduction was computed using a method resulting in an amount of interest for a period that exceeds the true cost of the indebtedness for the period computed by applying the effective rate of interest on the loan to the unpaid balance of the loan for that period (*i.e.*, the economic accrual of interest for the period), provided the interest is not accrued with respect to indebtedness incurred in connection with (i) the purchase, refinancing, or improvement of the principal residence of the taxpayer, or (ii) the purchase of consumer goods by the taxpayer (see Rev. Rul. 83-84, 1983-1 C.B. 97, and sections 163(e), 446(b), and 483);

(4) Any deduction disallowed for any period under section 709, relating to organization or syndication expenditures of a partnership;

(5) In the case of any expenditure described in section 248(b) that was incurred by an S corporation, any deduction disallowed because it exceeds the amount allowable under section 248, relating to organizational expenditures;

(6) Any deduction disallowed for any period under section 267(a), relating to transactions between related taxpayers;

(7) Any deduction disallowed for any period, or any income required to be included for any period, under section 467, relating to certain payments for the use of property or services;

(8) Any deduction disallowed for any period under section 461(i), relating to certain deductions of tax shelters; and

(9) In the case of a taxpayer who computes taxable income using the cash receipts and disbursements method of accounting, any deduction disallowed for any period because (i) the expenditure resulting in the deduction was a deposit rather than a payment, (ii) the expenditure was prepaid for tax avoidance purposes and not for a business purpose, or (iii) the deduction resulted in a material distortion of income (see, *e.g.*, Rev. Rul. 79-229, 1979-2 C.B. 210).

(within the meaning of section 6659(c)[4]) and to losses which are disallowed by reason of section 465(a).[5] Specifically, he contends that the partnership's losses resulted, for the most part, from excessive deductions for depreciation of the film caused by an overvaluation of the partnership's interest (if any) in the film. He also maintains that, if it is determined that the petitioners incurred deductible losses in 1978 and 1979 with respect to their investment in the partnership, the deductible portions of such losses are limited to the amount the petitioners were "at risk."[6] The petitioners object to the Commissioner's proposed amendment as being unfairly prejudicial to them, because it would necessitate further trial and briefing.

Under section 6214(a), this Court has jurisdiction to consider a claim by the Commissioner for an increased deficiency or addition to tax at any time before the entry of a final decision. *Ferrill v. Commissioner*, 684 F.2d 261, 265 (3d Cir. 1982), affg. per curiam a Memorandum Opinion of this Court; *Henningsen v. Commissioner*, 243 F.2d 954 (4th Cir. 1957), affg. 26 T.C. 528 (1956)[7]; see *Koufman v. Commissioner*, 69 T.C. 473 (1977). However, section 6214(a) does not give the Commissioner an unqualified right to amend his answer to claim an increased deficiency, addition to tax, or penalty. *Commissioner v. Long's Estate*, 304 F.2d 136 (9th Cir. 1962), affg. unreported orders of

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[4]Sec. 6659(c), as amended by the Tax Reform Act of 1984, Pub. L. 98-369, 98 Stat. 682, defines a "valuation overstatement":

SEC. 6659(c). VALUATION OVERSTATEMENT DEFINED.—For purposes of this section, there is a valuation overstatement if the value of any property, or the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).

[5]Sec. 465(a) provides, in part, as follows:

SEC. 465(a). LIMITATION TO AMOUNT AT RISK.—
(1) IN GENERAL.—In the case of—
(A) an individual, * * *

* * * * * * *

engaged in an activity to which this section applies, any loss from such activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of subsection (b)) for such activity at the close of the taxable year.

[6]Although the Commissioner also has disallowed the petitioners' claimed losses on the ground that the partnership was not an activity engaged in for profit, he does not rely on sec. 301.6621-2T, Q-4 and A-4, Proced. & Admin. Regs. (Temporary), wherein the list of "tax motivated transactions" is expanded to include "Any deduction disallowed for any period under section 183, relating to an activity engaged in by an individual or an S corporation that is not engaged in for profit." See note 3 *supra*.

[7]*Chanib v. Commissioner*, T. C. Memo. 1972-174, affd. per curiam 492 F.2d 1182 (6th Cir. 1974).

this Court; *Commissioner v. Erie Forge Co.*, 167 F.2d 71 (3d Cir. 1948), affg. a Memorandum Opinion of this Court; *Koufman v. Commissioner*, *supra*. Section 7453 expressly authorizes this Court to adopt rules governing practice before it, and the Commissioner, like any other party before this Court, is required to conform to such rules. *Commissioner v. Long's Estate*, *supra*; *Commissioner v. Erie Forge Co.*, *supra*; *Koufman v. Commissioner*, *supra*. Under Rule 41(a), pleadings may be amended after the case has been placed on a trial calendar and over the objection of the opposing party only by leave of the Court "when justice so requires." Whether a motion seeking amendment should be allowed is within the sound discretion of the Court, and its decision will not be reversed unless it abuses its discretion. *Commissioner v. Long's Estate*, *supra*; *Commissioner v. Erie Forge Co.*, *supra*.

In determining the justice of a proposed amendment, we must examine the particular circumstances in the case before us, for the exercise of discretion "may never be arbitrary and must be controlled by sound reason and fairness." *California Brewing Association v. Commissioner*, 43 B.T.A. 721, 725 (1941). If there is evidence of surprise or substantial disadvantage to the petitioner, the Commissioner's motion to amend should be denied because the purpose of section 6214(a) is to give the petitioner a fair opportunity to answer and resist the claim before it is considered by the Court. *Ferrill v. Commissioner*, *supra* at 265; *Henningsen v. Commissioner*, *supra* at 959; *Helvering v. Edison Securities Corp.*, 78 F.2d 85, 91 (4th Cir. 1935), affg. in part and remanding 29 B.T.A. 483 (1933). On the other hand, in cases where there was no evidence of surprise or prejudice to the petitioner, this Court has been reversed for refusing to allow the Commissioner to amend his answer to claim an increased deficiency, even after the Court has filed its opinion. *Commissioner v. Ray*, 88 F.2d 891 (7th Cir. 1937), revg. a Memorandum Opinion of this Court; see *Buffalo Union Furnace Co. v. Helvering*, 72 F.2d 399 (2d Cir. 1934), revg. on this issue 23 B.T.A. 439 (1931).

In the present case, while we are not convinced that the proposed amendment would require a further trial, we are of the opinion that it presents new legal issues of which the petitioners were without notice when they submitted their brief in answer. The petitioners would be severely prejudiced if

we were to permit the Commissioner to raise this new issue so late in the proceedings.

Section 6621(d) was enacted on July 18, 1984, after the trial of this case. In connection with the enactment of such provision, the Conference observed:

> The conferees believe that, with this amendment, the Congress has given the Tax Court sufficient tools to manage its docket, and that the responsibility for effectively managing that docket and reducing the backlog now lies with the Tax Court. * * * [H. Rept. 98–861 (Conf.) (1984), 1984–3 C.B. (Vol. 2) 1, 239.]

Thus, Congress apparently contemplated that broad use would be made of the authority to impose additional interest on underpayments of tax attributable to tax motivated transactions.

On January 10, 1985, Chief Judge Howard A. Dawson, Jr., announced, on behalf of the Tax Court:

> certain procedures that will be followed by the Court when the Commissioner of Internal Revenue claims additional interest under section 6621(d) of the Internal Revenue Code of 1954.
>
> * * * * * * *
>
> It is estimated that there are about 22,000 cases now pending in the Tax Court which involve alleged tax shelters. If the Commissioner moved for leave to amend his answers in those cases to claim the additional interest under section 6621(d), the processing of all such motions would present the Court with a staggering problem. To avoid the Commissioner filing written motions in all such cases, the Court has decided to adopt the following procedures in cases now pending before the Court to be tried or to be submitted as fully stipulated:
>
> If the Commissioner gives adequate and timely written notice to the petitioner or his counsel of his intention to claim additional interest under section 6621(d), the counsel for the Commissioner may, at the trial session where the case is to be tried or submitted, make a motion, either orally or in writing, for leave to amend his answer to claim the additional interest. The Court will act favorably on such motion and allow the Commissioner to amend his answer, but it will be necessary for the Commissioner to submit a written amendment to his answer specifying the tax motivated transactions which he claims gave rise to the substantial underpayment. The Commissioner shall also serve such amendment on the petitioner.
>
> Judge Dawson advises that no inference should be drawn from this announcement as to what position the Court will adopt in other circumstances.

Such announcement did not deal with the treatment of motions in cases already tried; the Commissioner's motion in this case requires us to face that question now.

In some cases, it is obvious that to allow the Commissioner to raise an issue under section 6621(d) after the trial would be prejudicial to the petitioner. For example, if the Commissioner claims that there was an underpayment of tax attributable to a tax motivated transaction described in his regulations under section 6621(d)(3)(A)(iv) or (B), the petitioner would be prejudiced if he was denied an opportunity to submit legal arguments in objection to such regulations, and he might be prejudiced if he was denied an opportunity to present evidence regarding the effect of such transactions. Thus, it would be an abuse of discretion for this Court to allow the Commissioner to amend his answer and claim additional interest under section 6621(d) in all cases after a trial. See *Commissioner v. Erie Forge Co.*, 197 F.2d at 903; *Estate of Horvath v. Commissioner*, 59 T.C. 551, 555–556 (1973); cf. *Ferrill v. Commissioner*, 684 F.2d at 265; *Henningsen v. Commissioner*, 243 F.2d at 959.

In the present case, the Commissioner argues that section 6621(d) is applicable because there was an overvaluation of property described in section 6621(d)(3)(A)(i) or a disallowance of losses described in section 6621(d)(3)(A)(ii). He maintains that those matters were at issue in the trial of the case, that the petitioners had an opportunity to present any evidence that they wished to establish that such transactions did not occur, and that in their brief, the petitioners had an opportunity to present any relevant arguments concerning such transactions. Under such circumstances, the Commissioner takes the position that the petitioners would not be prejudiced by allowing him to raise this issue at this time.

If, in fact, there is no additional evidence or arguments that the petitioners can present, granting the Commissioner's motion would not prejudice them, and it would be an abuse of discretion to deny the motion. *Commissioner v. Ray*, *supra*; *Buffalo Union Furnace Co. v. Helvering*, *supra*; cf. *International Banding Machine Co. v. Commissioner*, 37 F.2d 660 (2d Cir. 1930), revg. 12 B.T.A. 1062 (1928). Thus, it would be arbitrary for the Court to adopt the general practice of denying all motions by the Commissioner to claim additional interest when the motions are made after trial. It is necessary to

examine the particular circumstances of each case to ascertain whether the granting of such a motion would prejudice the petitioners.

As in so many shelter cases, the Commissioner here has asserted numerous, alternative grounds for the disallowance of all or portions of the partnership's losses. Not all of these grounds are listed as "tax motivated transactions." For example, the Commissioner's principal position with respect to the film depreciation deductions is that the partnership did not acquire a depreciable interest in the film. If we were to find that the partnership did not in fact acquire a depreciable interest in the film, we would not have to decide whether the film was overvalued in order to determine that the partnership was not entitled to a depreciation deduction. The Commissioner also contends that, if the partnership acquired a depreciable interest in the film, the amount of a promissory note given to purchase the film must be excluded from the film's basis because the debt was too contingent. If we were to disallow a portion of the partnership's depreciation deductions on this ground, we likewise might not have to determine whether the film was overvalued. See, e.g., *Estate of Baron v. Commissioner*, 83 T.C. 542, 549 (1984), on appeal (2d Cir., Mar. 26, 1985). Similarly, in other movie shelter cases, we have disallowed depreciation deductions without reaching the valuation issue where the partnership involved had misapplied the income forecast method of depreciation. See, e.g., *Greene v. Commissioner*, 81 T.C. 132 (1983); *Wildman v. Commissioner*, 78 T.C. 943 (1982). In cases involving alternative grounds, the Commissioner may contend that section 6621(d) requires us to decide issues which we might otherwise avoid, in order that the additional interest may be collected. On the other hand, the petitioner might maintain that, if no difference in the amount of the deficiency would result, we must decide the case on a ground, if available, which is not a "tax motivated transaction" for purposes of section 6621(d). Furthermore, if we were to decide that there is a deficiency on several alternative or overlapping grounds, some of which are listed as "tax motivated transactions" and some of which are not, the parties may dispute whether all, a part, or none of such underpayment is "attributable to" the "tax motivated transactions."

Because there are significant legal questions which might be raised as to the application of section 6621(d) to the present case, we hold that the Commissioner may not seek to amend his answer to invoke such section after the petitioners have submitted their final brief. However, we express no opinion as to the suitability of amending an answer after briefs have been submitted where the sole issue in the case is the overvaluation of a single asset (such as in a charitable contribution case) or is the disallowance of losses under the "at risk" rules of section 465(a). Obviously, the multiplicity of transactions and issues which may be involved in other cases prevents us from establishing a hard and fast rule.

An appropriate order will be entered.

Reviewed by the Court.

DAWSON, FAY, STERRETT, WILBUR, CHABOT, NIMS, PARKER, SHIELDS, CLAPP, SWIFT, JACOBS, and WRIGHT, *JJ.*, agree with the majority opinion.

KÖRNER, HAMBLEN, COHEN, and GERBER, *JJ.*, did not participate in the consideration of this case.

WHITAKER, *J.*, concurring: Our Rule 41(a) governs amendments to pleadings under the circumstances of this case.[1] As here pertinent, the rule specifies that "leave [to amend] shall be given freely when justice so requires." The majority appears to interpret the rule to preclude amendments only where there is prejudice[2] to the opposite party. But prejudice may be avoided where the new issue either needs no new evidence or the record is reopened to receive new evidence and the opposing party is allowed to present new arguments. Either or both of these solutions could have been applied to avoid prejudice here. But the majority further refines the rule to deny leave to amend after the filing of petitioner's final brief when "significant legal questions" are or may be raised by the amendment. The majority implies that if no significant

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[1] Rule 41(b) is not applicable. This issue was not tried by express or implied consent.

[2] Although the majority use the terms "surprise" and "substantial disadvantage" as well as "prejudice," the latter appears to be all inclusive.

legal questions were raised we should allow the amendment. While I agree with the result, I travel there by a different path.

I am not convinced that the work "justice" in our Rule is always satisfied if prejudice is avoided. We should allow an amendment when required by justice, but we should also deny leave to amend when justice so requires, irrespective of prejudice. In this case, both justice and economy of judicial effort dictate the denial of leave to amend the answer irrespective of whether or not significant legal questions are presented.

It should be an exceedingly rare occasion when we would allow respondent to increase the claimed deficiency against the petitioner or assert a new ground by amendment to the answer after a case has been submitted. In the case before us, respondent's motion was filed more than 8 months after trial and 10 days after petitioner's brief was filed. The Tax Reform Act of 1984 became law a few days after the trial of this case, and respondent sat on his opportunity to amend for more than 8 months. It seems to me that justice does not require petitioners to incur additional and to some extent duplicative legal expense to respond to this new issue which could have been raised well before any work had started on petitioner's brief.

Moreover, although section 6621(d) clearly is intended to be applied to interest accruing after December 31, 1984, the conferees also intended this provision to assist this Court in "managing" our docket and "reducing" our backlog. While we were admonished "to assert, without hesitancy in appropriate instances, the penalties" provided us, including section 6621(d), it is obvious that reopening the record in a submitted case for evidence or briefing so as to permit retroactive application of this statute to these petitioners hinders management of our docket and reduction of our backlog. Neither is there any reason to believe that such application of the statute would have any proper "in terrorem" effect on these or other taxpayers. It might be apprehended as simply abusive. In the absence of clearer direction from Congress, this is simply not an "appropriate" case for the application of section 6621(d). Both justice and judicial economy, not the presence or absence

of significant legal issues, require the denial of leave to amend. I would deny respondent's motion on these grounds.

GOFFE, *J.*, agrees with this concurring opinion.

ELI LILLY AND COMPANY AND SUBSIDIARIES, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 5113–76. Filed May 28, 1985.

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1. Petitioner is engaged in the manufacture and sale of pharmaceutical products. Petitioner created and patented pro-

poxyphene hydrochloride (Darvon) during the early 1950's and propoxyphene napsylate (Darvon-N) during the early 1960's. Darvon was first introduced into the U.S. market in 1957, and was manufactured by petitioner from 1957 to 1966. Darvon-N was not introduced into the U.S. market until 1971 and was never manufactured by petitioner. In 1965, petitioner organized Lilly P.R. as a wholly owned Puerto Rican subsidiary qualifying for the benefits of sec. 931, I.R.C. 1954. In December 1966, petitioner transferred the Darvon and Darvon-N patents and related manufacturing know-how to Lilly P.R. in a sec. 351, I.R.C. 1954, nonrecognition transaction. After 1966 and throughout the years in issue, Lilly P.R. manufactured Darvon and Darvon-N for sale to petitioner who in turn marketed the products throughout the United States. *Held*, Lilly P.R.'s ownership of the manufacturing intangibles is recognized in determining arm's-length prices between Lilly P.R. and petitioner. *Held, further*, the prices Lilly P.R. charged petitioner caused a distortion of income justifying reallocations.

2. *Held*, although reallocations of income were warranted, respondent's adjustments to prices under sec. 482, which denied Lilly P.R. any income from the manufacturing intangibles, were unreasonable.

3. During 1971 and 1972, Lilly P.R. was the sole manufacturer of Darvon and Darvon-N. These drugs were nonnarcotic analgesics which competed in the prescription pain relief market with combinations of codeine with aspirin or acetaminophen. At the end of 1972, the Darvon patent expired and, shortly thereafter, several companies began to compete directly with Darvon by manufacturing and marketing generic propoxyphene hydrochloride products. *Held*, arm's-length prices determined for 1971 and 1972 under sec. 1.482-2(e)(1)(iii), Income Tax Regs. *Held, further*, arm's-length prices for 1973 determined under sec. 1.482-2(e)(2), Income Tax Regs.

Thomas M. Haderlein, John C. Klotsche, Michael Waris, Jr., Gregg D. Lemein, Paul J. Linstroth, and *James M. O'Brien*, for the petitioners.

Joel V. Williamson, Charles S. Triplett, and *Joseph R. Goehe*, for the respondent.

WILES, *Judge*: Respondent determined deficiencies in petitioners' Federal income taxes as follows:

Year	*Deficiency*
1971	$7,622,449
1972	7,340,867
1973	6,853,816

By amendment to his answer, respondent asserted increased deficiencies in the following amounts:

Year	*Deficiency*[1]
1971	$11,711,792
1972	11,626,363
1973	10,882,192

The entire amounts of the deficiencies determined by respondent for 1971 and 1972 are in dispute, and petitioners claim refunds for 1971 and 1972 in the amounts of $1,700,038 and $1,697,257, respectively. For 1973, all but $189,048 of the deficiency determined by respondent is in dispute.

Pursuant to petitioners' motion, this Court severed from the case all issues other than the propriety of respondent's allocations of gross income under section 482[2] from Eli Lilly & Co., Inc. (hereinafter Lilly P.R.) to petitioner Eli Lilly Co. (hereinafter petitioner) with respect to Darvon® and Darvon-N® products. The severed issues were consolidated with docket No. 19606-80 for purposes of trial, briefing, and opinion; consequently, a final decision as to the income tax deficiencies of petitioners for the taxable years 1971, 1972, and 1973 will not be possible based upon the opinion of this case.

The section 482 allocations of gross income from Lilly P.R. to petitioner with respect to Darvon and Darvon-N products determined by respondent in his notice of deficiency and amendment to answer are as follows:

Year	*Notice of deficiency*	*Amendment to answer*
1971	$18,522,924	$26,620,387
1972	17,820,986	26,314,918
1973	10,717,187	18,078,205

These allocations raise the following questions for our consideration:

1. Whether petitioner's 1966 transfer pursuant to section 351 of certain Darvon and Darvon-N income-producing intangibles to Lilly P.R., a wholly owned subsidiary corporation

[1] These and the above deficiencies include amounts attributable to the issues severed from this case and consolidated with the case of petitioner in docket No. 19606-80.

[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

engaged in manufacturing in Puerto Rico and qualifying as a possessions corporation within the meaning of section 931, should be recognized for the purposes of determining arm's-length prices for Darvon and Darvon-N products purchased by petitioner from Lilly P.R. during 1971, 1972, and 1973;

2. Whether respondent's determinations that gross income should be allocated from Lilly P.R. to petitioner with respect to Darvon and Darvon-N products for the years 1971, 1972, and 1973 were arbitrary, capricious, or unreasonable;

3. Whether Lilly P.R.'s prices to petitioner for Darvon and Darvon-N products manufactured by Lilly P.R. and sold to petitioner during 1971, 1972, and 1973 were prices at which those products would have been sold between unrelated parties dealing at arm's length.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

I. *History and Background of Eli Lilly & Co.*

A. *Petitioner*

Petitioner is an Indiana corporation whose principal place of business at the time of filing the petition herein was Indianapolis, Indiana. During the years 1971, 1972, and 1973, petitioner and its consolidated subsidiaries maintained their books and records on the accrual method of accounting with taxable years beginning on January 1 and ending on December 31. Petitioner and its consolidated subsidiaries filed consolidated Federal income tax returns on Forms 1120 for the taxable years 1971, 1972, and 1973, at the Memphis Service Center, Memphis, Tennessee.

Petitioner is engaged in the United States in the invention, development, manufacture, marketing, and sale of a wide variety of ethical (i.e., prescriptions) and other pharmaceutical products, as well as certain agricultural, chemical, and cosmetic products. Petitioner is engaged in similar activities in approximately 145 countries throughout the world through a network of approximately 70 partially and wholly owned domestic and foreign corporations. During the time period

1960 through 1975, petitioner and its subsidiaries employed from 10,000 to 24,000 individuals.

During the years 1971 through 1973, the relevant divisions and subsidiaries of petitioner and their respective responsibilities were as follows:

(a) Pharmaceutical Division: Marketing and sale of pharmaceutical products in the United States.

(b) Elanco Products Co.: Marketing and sale of animal health and agricultural products in the United States.

(c) Elizabeth Arden, Inc.: Marketing and sale of cosmetic products in the United States.

(d) Lilly Research Laboratories: Fundamental and developmental research in the life sciences.

(e) Production Operations Division: Operation of all manufacturing facilities in the United States.

(f) Lilly P.R.: Manufacture and sale of ethical pharmaceutical products in Puerto Rico.

(g) Lilly Industries Ltd.: Fundamental and developmental research in the life sciences and manufacturing, marketing, and sale of pharmaceutical, animal health, and agricultural products.

(h) Eli Lilly S.A., Geneva: International marketing, licensing, and holding company.

The consolidated net sales (excluding intercompany sales) of petitioner and its worldwide subsidiaries and the United States pharmaceutical net sales of petitioner for the years 1965 through 1973 were as follows (000's omitted):

Year	*Consolidated net sales*	*U.S. pharmaceutical net sales*
1965	$316,600	$176,358
1966	366,700	196,482
1967	408,400	212,829
1968	479,600	257,610
1969	537,200	284,501
1970	592,300	304,933
1971	723,300	338,321
1972	819,700	351,044
1973	972,500	368,915

During the years 1971 through 1973, approximately 60 percent of the consolidated sales of petitioner and its worldwide subsidiaries was attributable to the sale of pharmaceuti-

cal products.[3] During those years, petitioner marketed approximately 750 pharmaceutical products in the United States. Petitioner's pharmaceutical sales during that time accounted for approximately 7.5 percent of the total pharmaceutical industry sales in the United States, and its pharmaceutical products accounted for approximately 6.5 percent of the new and refilled prescriptions written in the United States.

B. *Lilly P.R.*

Lilly P.R. was organized under the laws of the State of Indiana on June 9, 1965, as a wholly owned subsidiary corporation of petitioner. Lilly P.R.'s principal place of business is located in the Commonwealth of Puerto Rico. During 1971, 1972, and 1973, Lilly P.R. maintained its books and records on the accrual method of accounting with taxable years beginning on January 1 and ending on December 31. Lilly P.R. filed Federal income tax returns on Forms 1120 for the taxable years 1971 through 1973 with the Office of International Operations, Philadelphia, Pennsylvania.

Lilly P.R. was organized by petitioner, among other reasons, to take advantage of the benefits provided by section 931 relating to income from sources within possessions of the United States. Since its inception, Lilly P.R. has been engaged in the manufacture of propoxyphene and other pharmaceutical products in the Commonwealth of Puerto Rico. During each of the years in issue, Lilly P.R.'s gross income satisfied the conditions set forth in subsections (1) and (2) of section 931(a).

II. *History and Background of Darvon and Darvon-N Products*

A. *Propoxyphene and Propoxyphene Hydrochloride*

The search for a nonaddictive synthetic analgesic having the pain relieving properties of morphine began in the late 1920's and was accelerated in later years by two events. The first of those events was the scarcity of morphine during World War II. The second came at the close of World War II when American scientific intelligence teams investigated German

[3] Of the remaining 40 percent, 30 percent was attributable to the sale of agricultural products and 10 percent was attributable to the sale of cosmetics.

wartime work on synthetic analgesics and published a report, referred to as the "Kleiderer Report," summarizing that work for the American scientific community. The Kleiderer Report dealt with a number of synthetic substances, one of which subsequently became known as methadone. Although methadone proved to be as effective an analgesic as morphine, it also proved to be as addictive as morphine. In response to the Kleiderer Report, an intensive research effort was mounted in the United States and abroad for a nonnarcotic, synthetic analgesic of the morphine class. Several major pharmaceutical companies, including petitioner, participated in that effort.

In 1951, Dr. Albert Pohland, a research chemist working at Lilly Research Laboratories, discovered propoxyphene and propoxyphene hydrochloride. Propoxyphene hydrochloride, the principal active ingredient in Darvon products, proved to be the first synthetic analgesic that acted on the central nervous system with only a negligible potential of addiction. U.S. Patent 2,728,779 (hereinafter the propoxyphene patent) was issued to petitioner as Dr. Pohland's assignee on December 27, 1955, pursuant to an application filed on December 3, 1952. The propoxyphene patent covered the chemical substance propoxyphene and the acid addition salts of propoxyphene, including propoxyphene hydrochloride. The propoxyphene patent expired on December 27, 1972.

Propoxyphene is an oral prescription analgesic medication that relieves pain by acting upon the pain receptors in the brain. Propoxyphene is prescribed by physicians for the relief of mild to moderate pain, such as severe headache pain, postsurgical pain, and pain from bone fractures. It is often prescribed for patients with pain who have unsuccessfully self-medicated with over-the-counter drugs such as aspirin and acetaminophen.[4] Aspirin and acetaminophen are peripherally acting analgesics that relieve pain by acting at the site in the body where the pain arises.

Although propoxyphene was discovered in 1951 and the propoxyphene patent was issued to petitioner in 1955, petitioner did not obtain its first approval to market a propoxyphene product in the United States from the Food and Drug Administration, Department of Health and Human Services (hereinaf-

[4]Acetaminophen is sold separately over the counter under such trademarks as Tylenol®.

ter the FDA) until September 9, 1957. Petitioner sold its propoxyphene hydrochloride products under the trademark Darvon, which trademark it registered on July 29, 1958.

During the period from 1957 through 1973, petitioner sold the following products containing propoxyphene hydrochloride as their principal active ingredient:

Identification code	*Description*
PU 364	Darvon 32 mg.
PU 365	Darvon 65 mg.
PU 366	Darvon with A.S.A.
PU 368	Darvon Compound
PU 369	Darvon Compound-65
PU 377	Darvo-Tran®
TA 1855	Stero-Darvon®

The letters "PU" in the identification code of a product indicate that the product is sold in capsule, or "Pulvule®," form. The letters "TA" indicate that the product is sold in tablet form. The propoxyphene hydrochloride products listed above are hereinafter referred to collectively as "Darvon products."

B. *Propoxyphene Napsylate*

Propoxyphene napsylate, another salt of propoxyphene, is a nonnarcotic analgesic closely related to propoxyphene hydrochloride. Propoxyphene napsylate was discovered by Dr. Verlin C. Stephens, a research chemist of Lilly Research Laboratories. U.S. Patent 3,065,261 (hereinafter the napsylate patent) was issued to petitioner as Dr. Stephens' assignee on November 20, 1962, pursuant to an application filed on December 14, 1960. The napsylate patent, covering the napsylate acid addition salts of propoxyphene, expired on November 20, 1979.

Propoxyphene napsylate and propoxyphene hydrochloride are medically identical as far as pain relief is concerned. However, because the molecular weight of propoxyphene napsylate is greater than that of propoxyphene hydrochloride, a dose of 100 milligrams of propoxyphene napsylate is required to supply an amount of propoxyphene equivalent to that present in 65 milligrams of propoxyphene hydrochloride. Also, whereas propoxyphene hydrochloride is freely soluble in water, propoxyphene napsylate is only slightly soluble in

water. As a result of that difference, the napsylate salt has certain advantages over the hydrochloride salt. First, suspension (i.e., liquid) and tablet formulations of the napsylate salt are more stable than those of the hydrochloride salt. The greater stability of the napsylate salt thus makes it easier to disguise propoxyphene's intensely bitter taste. Second, the napsylate salt does not react with aspirin and, as a result, combinations of aspirin and the napsylate salt do not present the same problems as those that occur in combinations of aspirin and the hydrocholoride salt.[5] Finally, because the napsylate salt is less soluble than the hydrochloride salt, it is not absorbed into the bloodstream as quickly as the hydrochloride salt, which results in less stomach irritation than that occurring in some patients using the hydrochloride salt and which allows more time for emergency measures in overdose situations.

Petitioner obtained its first FDA approval to market a propoxyphene napsylate product in the United States on September 9, 1971. Petitioner sold its propoxyphene napsylate products under the trademarks Darvocet-N® and Darvon-N, which were registered by petitioner on January 1, 1973, and February 6, 1973, respectively.

During the years 1971 through 1973, petitioner sold the following products containing propoxyphene napsylate as their principal active ingredient:

Identification code	*Description*
TA 1883	Darvon-N
TA 1884	Darvon-N with A.S.A.
MS 135	Darvon-N Suspension
TA 1890	Darvocet-N 50

The letters "MS" in the identification code indicate that the product is sold in the form of a liquid suspension. The propoxyphene napsylate products listed above are hereinafter referred to collectively as "Darvon-N products."

C. *Success of Darvon and Darvon-N Products*

Darvon and Darvon-N products were the most often pre-

[5] When propoxyphene hydrochloride is mixed with aspirin (acetylsalicylic acid), the aspirin tends to deteriorate in the presence of moisture into its component parts: acetic acid, which smells like vinegar, and salicylic acid, which is a highly irritating substance.

scribed ethical pharmaceutical products in the United States during the period 1960 through 1973. During each of the years 1958 through 1973, Darvon or Darvon-N products were among the 10 largest selling ethical pharmaceutical products in the United States.

During the years 1971 through 1973, Darvon and Darvon-N products competed in the market for medications for the relief of mild to moderate pain, and their principal competitors were combinations of codeine with aspirin, acetaminophen, or other peripherally acting analgesics. During the years 1958 through 1972, while the propoxyphene patent was in effect, Darvon and Darvon-N products occupied 100 percent of the propoxyphene market in the United States. In 1973, after the propoxyphene patent expired, Darvon and Darvon-N products occupied approximately 98 percent of the propoxyphene market in the United States.

Petitioner's sales of Darvon and Darvon-N products in the United States during the years 1958 through 1973 were as follows (000's omitted):

Year	*Darvon*	*Darvon-N*	*Total*
1958	$6,900	0	$6,900
1959	9,700	0	9,700
1960	14,000	0	14,000
1961	19,700	0	19,700
1962	24,800	0	24,800
1963	24,400	0	29,400
1964	36,700	0	36,700
1965	38,800	0	38,800
1966	44,600	0	44,600
1967	50,300	0	50,300
1968	60,400	0	60,400
1969	65,100	0	65,100
1970	69,300	0	69,300
1971	69,800	$4,100	73,900
1972	66,500	9,300	75,800
1973	53,400	16,600	70,000

Petitioner's net income before taxes on U.S. sales of Darvon products for the years 1958 through 1965, based upon petitioner's method of allocating expenses, was as follows (000's omitted):

Year	Net income before taxes
1958	$1,600
1959	4,200
1960	5,100
1961	13,000
1962	17,900
1963	22,200
1964	28,200
1965	30,200

Petitioner's and Lilly P.R.'s consolidated net income before taxes on U.S. sales of Darvon and Darvon-N products (Darvon-N products in 1971 through 1973 only) for the years 1966 through 1973, based upon petitioner's method of allocating expenses, was as follows (000's omitted):

Year	Net income before taxes
1966	$32,700
1967	37,600
1968	43,700
1969	43,400
1970	47,100
1971	50,500
1972	49,100
1973	40,700

III. *Manufacture of Darvon and Darvon-N Products*

A. *Overview of Petitioner's Manufacturing Operations*

During the 1950's and 1960's, petitioner maintained bulk chemical manufacturing facilities in Indianapolis, Indiana, at which chemical synthesis, antibiotic fermentation, and insulin manufacturing operations were conducted. Pharmaceutical manufacturing operations (i.e., product formulation, encapsulation or tableting, and packaging), were also conducted at the Indianapolis facilities. In 1953, petitioner started an antibiotic fermentation operation at its new Tippecanoe Laboratories facility in West Lafayette, Indiana. Chemical synthesis operations were begun at Tippecanoe Laboratories in 1958.

Because the manufacturing techniques and technology and the training of production personnel in chemical manufacturing are vastly different from those involved in pharmaceutical manufacturing, it is a common industry practice to physically

separate chemical and pharmaceutical manufacturing operations. Chemical synthesis operations involve continuous reactions that cannot be stopped, thereby requiring 24-hour-a-day operations. They also entail water and air pollution problems, the handling of dangerous chemicals, and a substantial demand for utilities such as water and steam. Furthermore, chemical manufacturing operations are capital intensive. In contrast, pharmaceutical manufacturing operations are labor intensive, are conducted in very clean environments, and do not place a great demand on utilities or require 24-hour-a-day operations.

During the years 1971 and 1973, petitioner maintained separate chemical and pharmaceutical manufacturing facilities. Its pharmaceutical manufacturing operations were conducted in its plants on Kentucky Avenue and McCarty Street in Indianapolis, Indiana, and its chemical manufacturing operations for pharmaceutical products were conducted at its plants in West Lafayette and Clinton, Indiana. The Clinton plant became operational in 1971.

B. *Manufacture of Darvon Products*

The manufacture of Darvon products consists of two distinct phases: (a) the chemical manufacturing phase, involving the production of the bulk chemical propoxyphene hydrochloride; and (b) the pharmaceutical manufacturing phase, involving formulating or mixing the bulk chemical with other active and/or inactive ingredients, encapsulating the formulated product or compressing it into tablets, and packaging and labeling the capsules or tablets.

Prior to full-scale commercial production of Darvon products, petitioner developed manufacturing techniques at its chemical and dry products pharmaceutical pilot plants in Indianapolis, Indiana. Petitioner's pilot plants were departments of Lilly Research Laboratories during the years 1955 through 1973.

The functions of petitioner's chemical pilot plant were to scale up the chemical manufacturing processes for new chemicals from laboratory quantities to commercial quantities and to provide materials for clinical trials and toxicological testing. (Clinical trials and toxicological testing, both of which are important in the development and FDA approval of a new

pharmaceutical product, will be discussed later in detail.) When a new chemical is first identified and undergoes its initial testing, only small quantities of the chemical are produced in the laboratory. The new chemical is transferred to the pilot plant for the development of an economical process for manufacturing the chemical in commercial quantities. The pilot plant development also identifies any special equipment that might be required to perform the process. When the chemical is placed in production at the chemical manufacturing plant, pilot plant personnel ordinarily will participate in the startup of the full-scale manufacturing process.

Upon the completion of pilot plant development of propoxyphene hydrochloride, petitioner in 1957 began full-scale commercial production of propoxyphene hydrochloride at a chemical manufacturing facility in Indianapolis, Indiana. The chemical manufacture of propoxyphene hydrochloride was transferred from Indianapolis to petitioner's Tippecanoe Laboratories in West Lafayette, Indiana, in 1960. Chemical manufacture of other products had begun at Tippecanoe Laboratories as early as 1958, when petitioner designated that facility as its site for future expansion of chemical manufacturing. Eventually, petitioner closed its Indianapolis chemical manufacturing facility.

From 1960 through 1965, petitioner produced propoxyphene hydrochloride in various buildings at Tippecanoe Laboratories. As a result of its need for additional chemical manufacturing facilities, petitioner, in 1965, constructed a new building (called Building T28) to house the production of propoxyphene hydrochloride, which by then had become a substantial product. Building T28 was constructed at an approximate cost of $2 million and occupied 12,000 square feet, excluding warehouse and central services. From January 1, 1966, to December 5, 1966,[6] bulk propoxyphene hydrochloride was produced in Building T28, requiring a total of approximately 20 direct manual and machine operators for all three 8-hour shifts plus numerous support and management personnel.

[6] Subsequent to Dec. 5, 1966, petitioner manufactured 700 kilograms of propoxyphene hydrochloride pursuant to a license agreement with Lilly P.R., and obtained 2,607.2 kilograms of propoxyphene hydrochloride from recovery, rework, or cleanup of lots of propoxyphene hydrochloride manufactured by petitioner in 1966, prior to its assignment of the propoxyphene and napsylate patents to Lilly P.R.

During the years 1957 through 1965, bulk propoxyphene hydrochloride was transported from the chemical manufacturing facility at either Indianapolis or Tippecanoe to petitioner's Kentucky Avenue plant in Indianapolis for use in the pharmaceutical manufacture of Darvon products. During that period, petitioner also manufactured the empty capsules for Darvon products at the Kentucky Avenue plant.

During the period 1957 to December 5, 1966, petitioner manufactured and sold Darvon products only in bottles of 100 and bottles of 500 capsules. The following Darvon products were manufactured and sold by petitioner during that period:

Identification code	*Description*
PU 364	Darvon 32 mg.
PU 365	Darvon 65 mg.
PU 366	Darvon with A.S.A.
PU 368	Darvon Compound
PU 369	Darvon Compound-65
PU 377	Darvo-Tran

C. *Manufacture of Darvon-N Products*

Darvon-N products were first sold by petitioner in 1971. Petitioner never commercially manufactured bulk propoxyphene napsylate or Darvon-N products in the United States. The Darvon-N products sold by petitioner in 1971, 1972, and 1973 were manufactured solely by Lilly P.R.

D. *Development of Manufacturing Know-How*

1. *Chemical Manufacture*

As stated earlier, petitioner manufactured bulk propoxyphene hydrochloride from 1957 to December 5, 1966. The actual chemical synthesis involved was done in a six-step sequence: (1) Propiophenone, (2) iso butyro phenone derivative base, (3) carbinol derivative crude, (4) dextro carbinol camphor sulfonate, (5) dextro carbinol base, and (6) propoxyphene hydrochloride.

The processes and techniques used by petitioner to manufacture the bulk chemical propoxyphene hydrochloride generally were standard in the pharmaceutical industry. However, over a period of several years, petitioner in the chemical pilot plant of Lilly Research Laboratories and in its chemical manufactur-

ing plants developed[7] methods of production allowing increased batch size, fewer raw materials, and lower unit costs. As a result of petitioner's efforts, its cost of producing propoxyphene hydrochloride declined from about $125 per kilogram in 1957 to about $30 per kilogram in 1960.

The basic chemistry underlying each of the chemical reactions involved in the manufacture of propoxyphene hydrochloride is well known in the pharmaceutical industry. A skilled chemist could ascertain the basic chemical reactions involved once he knew the molecular structure of the final product. However, the details of the processes used by petitioner in carrying out those reactions could not be ascertained by analysis of the finished product and is not known outside of petitioner and certain of its subsidiaries.

The processes used by petitioner to manufacture propoxyphene hydrochloride were not discussed in the propoxyphene patent, and, in fact, the patent application was filed in 1952, long before the processes themselves were developed. The propoxyphene patent was not a so-called "process" patent, but rather covered the chemical substances propoxyphene and propoxyphene hydrochloride, which are not produced until the sixth and final step. Petitioner did not attempt to patent the processes it developed to manufacture propoxyphene hydrochloride, which may or may not have been patentable, because process patents disclose the details of the processes they cover and are difficult and costly to enforce. Petitioner, instead, relied upon secrecy to preserve the value of the manufacturing know-how involved in its manufacture of propoxyphene hydrochloride.

Petitioner disclosed its manufacturing know-how to production employees in documents called manufacturing or work tickets, which contained detailed processing instructions. The manufacturing tickets were kept in secure cabinets when not in use by the plan operators, and access to the production areas where the processes were performed was restricted.

The chemical reactions involved in the manufacture of bulk propoxyphene napsylate are precisely the same as those involved in the manufacture of bulk propoxyphene hydrochloride, from the first step through the production of propoxy-

[7] The term "developed" as we use it here includes, but is not limited to, the initiation, testing, and modification of the procedures involved.

phene base in the final step of the process. The only differences in the manufacture of the two salts are the agents and the manners of acidification of the propoxyphene base used in the last reactions to produce the salts.

The chemical manufacturing processes used in the manufacture of propoxyphene napsylate were developed in the chemical pilot plant of Lilly Research Laboratories during the period 1960 through 1963, soon after the discovery of propoxyphene napsylate. The napsylate patent, like the propoxyphene patent, was not a process patent, but rather covered the chemical substance itself. Accordingly, petitioner relied on secrecy to preserve the value of the manufacturing know-how involved in the manufacture of propoxyphene napsylate.

2. *Pharmaceutical Manufacture*

The last phase in the manufacture of Darvon products is the phase in which the bulk material, propoxyphene hydrochloride, is made into the pharmaceutical product, Darvon (and its various formulations).

Pharmaceutical manufacturing is primarily a mixing operation and rarely involves sophisticated chemical processes. The critical aspect of pharmaceutical manufacturing is the quality control and attention to detail necessary to perform each step accurately so that the final product is precisely what it is intended to be and conforms to the FDA-approved New Drug Application (hereinafter NDA)[9] for that product.

The manufacturing know-how necessary for the pharmaceutical manufacture of Darvon products was developed by petitioner during the years 1957 through 1966. In general, the processes and techniques so used by petitioner during those years were standard in the pharmaceutical industry. During the early 1960's, however, petitioner developed a method allowing it to improve its formulations of Darvon products containing aspirin. In the presence of moisture, propoxyphene hydrochloride causes aspirin to decompose and to form acetic acid and free salicylic acid. The FDA has established limits on the level of free salicylic acid, a highly irritating substance, allowed in products containing aspirin. Moreover, the presence of acetic acid in those products causes them to have the

[9] See pp. 1066–1068 for a definition and discussion of NDAs.

odor of vinegar. To prevent the decomposition of aspirin, petitioner developed a method whereby the propoxyphene hydrochloride was formed into a coated pellet, called a sphercote, which, when placed in a capsule with aspirin, prevented the interaction of the propoxyphene hydrochloride and the aspirin. Petitioner also developed a mechanical means of inspecting every capsule to insure that every capsule contained one, and only one, pellet of propoxyphene hydrochloride.

The pharmaceutical manufacturing of Darvon-N products is generally the same as that for Darvon products. Their only difference is that Darvon-N products are primarily in tablet, rather than capsule, form.

E. *Foreign Manufacture of Propoxyphene Products*

Propoxyphene products have never been patented in any foreign country. However, since 1963, petitioner and Lilly Industries Ltd. (hereinafter Limited), a wholly owned United Kingdom subsidiary of petitioner, have made available to each other patents, manufacturing know-how, and other scientific and technical data pursuant to a cross license agreement entered into by them on January 1, 1965. In the cross license agreement, petitioner granted to Limited the exclusive license to make, use, and sell petitioner's products in the United Kingdom. Pursuant to that license, Limited manufactured the bulk chemicals propoxyphene hydrochloride and propoxyphene napsylate and sold propoxyphene hydrochloride and propoxyphene napsylate final dosage form products in the United Kingdom through 1973.

IV. *Historical Development of the Puerto Rican Operations of Petitioner and Lilly P.R.*

A. *Puerto Rico's "Operation Bootstrap"*

In the 1940's, an economic development program began in Puerto Rico that later became known as "Operation Bootstrap." At first the program concentrated on land reform, public services, and Government ventures into industry. Later, its emphasis shifted to stimulating private investment. Under the Puerto Rican Industrial Incentive Act of 1954, eligible companies were entitled to a 10-year tax exemption from

Puerto Rican income taxes measured from the start of their manufacturing operations in Puerto Rico. In addition, exemptions were provided from certain property taxes, license fees, and excise taxes. A company was eligible for those exemptions if its proposed Puerto Rican operation would manufacture in Puerto Rico a product not manufactured there before January 2, 1947, or if it met other limited criteria.

On June 13, 1963, the Puerto Rican Industrial Incentive Act of 1963 was enacted. The new act retained virtually all of the provisions of the 1954 Act and added a number of new and more liberal provisions. One of the major new provisions provided for exemption periods of longer than 10 years if the Puerto Rican operations were conducted in a less developed area of Puerto Rico.

B. *Petitioner's 1961–62 Study of Possible Puerto Rican Operations*

From approximately June 1, 1961, through June 1, 1962, petitioner studied the possibility of establishing manufacturing operations in Puerto Rico. Petitioner had, at that time, received numerous visits from representatives of the Economic Development Administration of Puerto Rico attempting to interest petitioner in the economic development of that area. The visits included discussions of the tax advantages of doing business in Puerto Rico. As a result of those contacts, and in an effort to find out more about the possibilities of operating in Puerto Rico, petitioner designated a three-man team to visit Puerto Rico and to investigate the subject in detail.

During the 1961–62 study, petitioner considered the possible conduct in Puerto Rico of a wide range of manufacturing operations, including the manufacture of bulk chemicals, empty gelatin capsules, and finished capsule products. The study included consideration of the possibility of performing the chemical manufacture of propoxyphene hydrochloride in Puerto Rico.

In January 1962, the project team traveled to Puerto Rico to investigate the establishment of a manufacturing plant there. During that trip, the project team had extensive discussions with the law firm of McConnell, Valdes & Kelley; the accounting firm of Ernst & Ernst; branch banks of First National City Bank and Chase Manhattan Bank, as well as two Puerto Rican

banks, Banco Popular and Banco Ponce; the Economic Development Administration of Puerto Rico; and personnel of the Puerto Rican pharmaceutical manufacturing operations of Parke, Davis & Co. and Baxter Laboratories, Inc.

After returning from Puerto Rico, the project team developed an economic analysis of the proposed Puerto Rican manufacturing operations. In a memorandum dated April 30, 1962, the team recommended that petitioner file an application for a Puerto Rican industrial tax exemption for the pharmaceutical manufacture of capsule products in general. Although petitioner decided not to proceed with an operation in Puerto Rico at that time, due to the anticipated length of time required to obtain approval of an application for Puerto Rican tax exemption, it did decide to file an application for such an exemption. Petitioner filed its application for a Puerto Rican industrial tax exemption on June 20, 1962. The application was broadly drafted to cover the pharmaceutical manufacture of all petitioner's capsule products.

Petitioner's June 20, 1962, application for an industrial tax exemption was approved and the requested exemption was granted on May 29, 1963. The required commencement date of operations, May 29, 1964, was subsequently extended to May 29, 1965, and later to May 29, 1966.

C. *Petitioner's Second Puerto Rican Study 1965–66*

During 1964, petitioner initiated an exhaustive study project to develop an expansion program to meet adequately its projected 1975 requirements for dry pharmaceutical products.[9] Forecasts were prepared of product needs and the facilities necessary to meet those needs. Several alternatives were developed, including utilizing existing facilities with some additional construction as well as selecting a new plant site for current and future expansion. The presentation of the study to management in February 1965 precipitated a renewed interest in the possibility of Puerto Rico being the site of expanded facilities, although the original study did not contain that suggestion.

[9] The term "dry pharmaceutical products" refers to tablets and filled capsules which are taken orally as contrasted with other pharmaceutical products such as syringes, liquids, ointments, and injectable medications.

Petitioner's primary purpose for considering construction of a manufacturing plant in 1965 was to provide additional capacity to meet its projected 1975 production requirements. Petitioner attempted to operate its chemical and pharmaceutical manufacturing facilities at about 80 percent of full capacity. Petitioner traditionally operated its chemical manufacturing facilities three 8-hour shifts per day, five days a week, and its pharmaceutical manufacturing facilities one 8-hour shift per day, five days a week, thereby allowing petitioner to accommodate sudden demands for full capacity resulting from epidemics or the introduction of a new product by working overtime on weekends. In 1964 and 1965, petitioner's chemical and pharmaceutical manufacturing facilities were operating at more than 80 percent of full capacity and were becoming overcrowded.

Petitioner's need for additional manufacturing facilities continued throughout the period 1965 through 1973. As noted previously, Building T28 was built in 1965 at Tippecanoe Laboratories to relieve the overcrowding at that chemical manufacturing facility. Tippecanoe Laboratories again was expanded after 1965 to accommodate the transfer of chemical manufacturing operations to that facility from Indianapolis. In 1969, petitioner began construction of a new chemical manufacturing facility on a 684-acre site at Clinton, Indiana, which facility became operational in 1971. Petitioner's Kentucky Avenue facility, where all its pharmaceutical manufacturing operations for dry products were located, was especially overcrowded and the extent to which it could be expanded was limited. Therefore in 1973, petitioner began construction of a new manufacturing facility on a 160-acre site adjacent to its existing Kentucky Avenue facility.

Petitioner elected to locate the needed manufacturing operations in Puerto Rico for a variety of reasons. One reason for that decision was petitioner's desire to obtain the tax benefits provided by the Puerto Rican Industrial Incentive Act of 1963 and section 931. In addition, the establishment of manufacturing operations in Puerto Rico would geographically disperse petitioner's manufacturing facilities, which in 1965 were concentrated in Indianapolis and nearby communities in Indiana. During the 1960's, petitioner was concerned that its concentrated manufacturing facilities were overly exposed to

the risks of natural and man-made (i.e., nuclear) disasters. The concentration of all capsule and dry products pharmaceutical manufacturing operations at the Kentucky Avenue plant in Indianapolis was of special concern. A disaster at that location would have severely affected petitioner's ability to supply products to a substantial market segment. The possibility of such a disaster became apparent in April 1965, when a tornado caused great damage to an area just north of Indianapolis.

Finally, the establishment of manufacturing operations in Puerto Rico would allow petitioner to isolate the manufacture of a major product in a separate facility, thereby eliminating the possibility of cross-contamination problems.

From February 1965 to August 1966, petitioner conducted a second study specifically focusing on the development of Puerto Rican manufacturing operations. In March 1965, petitioner appointed a special project team to gather and evaluate information on the establishment and operation of a Puerto Rican manufacturing plant. The project team recognized that there were some disadvantages associated with a Puerto Rican operation. Puerto Rico's distance from the continental United States would create coordination and logistical problems in moving products to the market. There was concern with respect to the availability of a qualified labor force and the extent of training and development of employees that would be required. The team was also aware of the possibilities that natural disaster, political unrest, or labor strife would close the shipping lanes to Puerto Rico. Furthermore, a Puerto Rican operation would create additional governmental reporting requirements with their associated administrative expenses.

In view of the business objectives and the perceived disadvantages of operating in Puerto Rico, the project team recommended that a small number of large volume products should be selected for the Puerto Rican operation. Accordingly, the project team selected for further study Darvon and Ilosone® products, petitioner's largest volume dry products at that time.

The initial proposal considered by the project team in 1965 was an updated version of the proposal considered by petitioner in 1962. That proposal contemplated the establishment of a facility in Puerto Rico to manufacture empty capsules and

perform the pharmaceutical manufacture of all petitioner's Darvon and Ilosone capsule products for sale to petitioner. Under that proposal, the Puerto Rican operation would purchase its bulk chemicals from petitioner.

One of the significant problems the project team faced was the issue of intercompany pricing under section 482. In 1965, the Internal Revenue Service (hereinafter the Service) had not issued, in either proposed or final form, detailed regulations under section 482 relating to the sale of goods between related parties. The project team for the 1962 study had also recognized the existence of the section 482 issue. Essentially, the only guidance available to the 1962 project team was the statutory language of section 482, although it hoped that representatives of the Puerto Rican and U.S. Government would issue a set of ground rules relative to intercompany pricing prior to any actual decision to construct facilities in Puerto Rico. Subsequent to the conclusion of the 1962 study and prior to the inception of the second study in 1965, the Service issued Technical Information Release 441, later reprinted as Revenue Procedure 63–10, which set forth guidelines for the application of section 482 to transactions between mainland parents and Puerto Rican affiliated corporations. While the members of the project team in 1965 were familiar with the revenue procedure, they found that it did not eliminate all the uncertainty with respect to intercompany pricing.

On or about March 30, 1965, shortly after its formation, the project team obtained the assistance of petitioner's outside tax counsel, the law firm of Baker McKenzie & Hightower, and the accounting firm, Ernst & Ernst. In April 1965, at the suggestion of the outside tax counsel, the project team considered two variations of the initial proposal. First, the team considered the possible sale of the products manufactured in Puerto Rico direct to unrelated wholesalers in the United States rather than to petitioner for resale to such wholesalers. Second, the project team considered the possible manufacture of bulk chemicals in Puerto Rico by the Puerto Rican operation rather than in Indiana by petitioner. The two variations of the original proposal gave the project team the following four alternatives to analyze:

(a) Chemical manufacture in Indiana, pharmaceutical manufacture in Puerto Rico, and sales to petitioner (i.e., the original proposal);
(b) Chemical manufacture in Indiana, pharmaceutical manufacture in Puerto Rico, and sales direct to wholesalers;
(c) Chemical and pharmaceutical manufacture in Puerto Rico and sales to petitioner; and
(d) Chemical and pharmaceutical manufacture in Puerto Rico and sales direct to wholesalers.

For the purpose of analyzing these alternatives, the team assumed that the Puerto Rican operation would be a wholly owned subsidiary corporation, and that it would manufacture Darvon products only.

Members of the project team discussed the four alternatives with petitioner's outside tax counsel. Alternatives (c) and (d) were viewed as the most desirable because the Puerto Rican corporation would be using the propoxyphene patent in its chemical manufacturing operations, and the patent thus could be transferred to it in a nonrecognition transfer under section 351. Because the Puerto Rican corporation would own the patent, the outside tax counsel opined that it would be deemed to have earned the income attributable to the patent. Also, because the Puerto Rican corporation would own the patent and would manufacture the basic chemicals, the issue of the appropriate intercompany prices for bulk chemicals sold by petitioner to the Puerto Rican corporation would be eliminated. Furthermore, the transfer of the patent and chemical process to Puerto Rico would effect a complete separation of the manufacturing and marketing functions with respect to Darvon products, thus petitioner would be performing a pure marketing function and an appropriate transfer price from Puerto Rico could be determined by reference to third-party evidence of the value of that marketing function.

In comparing alternatives (c) and (d), the project team recognized that both involved the transfer of the propoxyphene patent to a corporation operating outside the United States. The team did not consider that a disadvantage, however, because the patent: (1) Would be owned by a wholly owned subsidiary corporation; (2) would be physically in the United States; (3) could be recovered by collapsing the subsidiary and merging it into petitioner; and (4) would not be subject to

expropriation. Although alternative (d) (sales direct to wholesalers) would enable the Puerto Rican operation to earn the larger amount of net income and would provide the greater number of arm's-length dealings with petitioner, the fact that wholesalers would have to deal with a second organization (the Puerto Rican operation) whenever they ordered, received, and paid for products manufactured in Puerto Rico was considered a major disadvantage and caused the project team to reject that alternative.

At a special meeting of petitioner's board of directors on May 5, 1965, the project team presented its proposal to establish facilities in Puerto Rico for the manufacture of chemicals and empty capsules and the pharmaceutical manufacture of capsule products. After discussion, the board approved the following resolutions:

> RESOLVED, That the establishment by Eli Lilly and Company (or a subsidiary or subsidiaries thereof) in the Commonwealth of Puerto Rico of facilities for the manufacture of chemicals and capsules and the filling and finishing of Pulvules® with an investment of up to approximately six and one-half million dollars ($6,500,000), be, and it is hereby, approved in principle.
>
> FURTHER RESOLVES, That the proper officers of the Company be, and they hereby are, authorized for and on behalf of the Company:
>
> a. to make such investigations, formulate such plans and to make such commitments as they may deem necessary to expedite the establishment of such facilities.
>
> b. to negotiate, with the Commonwealth of Puerto Rico, its agencies, subdivisions or municipalities in order to obtain necessary authorizations and a grant or grants of tax exemption pursuant to the Industrial Incentive Act of 1963, and to execute any and all documents that in their opinion may be necessary or proper for such purposes.
>
> c. to enter into lease(s) of facilities for use in the manufacture of products for a term not exceeding three (3) years.
>
> d. to execute option(s) to purchase real estate in the Commonwealth of Puerto Rico.
>
> FURTHER RESOLVED, That nothing contained in the foregoing resolutions shall be deemed to authorize or approve the appropriation of funds for capital expenditures.

Shortly after the special board of directors meeting on May 5, 1965, representatives of petitioner traveled to Puerto Rico to investigate possible sites for the construction of manufacturing facilities there. At that time, petitioner planned first to establish pharmaceutical manufacturing operations in a

leased facility in order to gain experience in operating a Puerto Rican plant and to begin taking advantage of the potential tax savings. Petitioner next intended to establish empty capsule manufacturing and pharmaceutical manufacturing on a permanent site owned by the Puerto Rican operation. To those ends, during May 1965, petitioner selected leased facilities in Hato Rey, Puerto Rico, and a permanent plant site in Carolina, Puerto Rico. Petitioner tentatively planned as its third step to establish chemical manufacturing facilities in a permanent site owned by the Puerto Rican operation; however, no definite decision was made to transfer all or part of the chemical manufacture of Darvon, or the propoxyphene patent, to the Puerto Rican operation at that time.

On May 25, 1965, members of the project team met with petitioner's outside tax advisers and discussed three aspects of the Puerto Rican operation: corporate structure, financial structure, and intercompany pricing. At that meeting, it was decided that the Puerto Rican operation would be conducted through a new, wholly owned Indiana subsidiary of petitioner that would qualify as a possessions corporation under section 931. It was also decided that the subsidiary corporation would be sufficiently capitalized so that it could borrow funds to maintain its operations until it was in full production without the necessity of a guarantee from petitioner. Although the issue of intercompany pricing was discussed extensively at that meeting, final intercompany pricing decisions were deferred until a decision was made with respect to the extent of the chemical manufacturing operations that would be conducted by the subsidiary.

Petitioner organized Lilly P.R. on June 9, 1965, as a wholly owned subsidiary corporation. On August 3, 1965, members of the project team and other employees of petitioner met to discuss the scope of Lilly P.R.'s chemical manufacturing operations and the related intercompany pricing issues. At that meeting it was informally decided that at least the last step in the propoxyphene hydrochloride manufacturing process (step 6 (propoxyphene hydrochloride)) and the propoxyphene patent should be transferred to Puerto Rico. There was still a question, however, with respect to whether step 1

(propiophenone), and to a lesser extent steps 2 through 5, should be transferred to Puerto Rico.

At a meeting on August 19, 1965, members of the project team and other employees of petitioner concluded that the entire chemical manufacturing process for propoxyphene hydrochloride should be transferred to Puerto Rico. That decision enabled the participants at the meeting to reach final decisions with respect to the transfer pricing of Lilly P.R.'s products. The participants decided that the Darvon products sold by Lilly P.R. to petitioner should be priced on a basis that would permit petitioner to recover its selling and distribution expenses plus a profit of 90 to 100 percent of those expenses, which was achieved by discounting petitioner's net wholesale prices for Darvon products by approximately 27.5 to 35 percent. The participants also decided that Lilly P.R. and petitioner should enter into a sales contract that would be reviewed periodically and would provide for rebates from Lilly P.R. to petitioner for sales of Darvon products by petitioner to the U.S. Government.

Petitioner's project team considered the profit margins of other companies selling finished pharmaceuticals in an attempt to determine an appropriate transfer price for Lilly P.R.'s products. The project team ideally was looking for a company that purchased finished pharmaceutical products from unrelated manufacturers and marketed such products to unrelated customers. The only company performing those functions that petitioner could identify was Marion Laboratories, Inc. The prospectus of that company indicated that its operating income expressed as a percentage of its operating expenses ranged from 5 to 53 percent for the years 1961 through 1965. The project team also examined the operating income to operating expense ratios of petitioner's international affiliates, which purchased finished pharmaceutical products and sold those products to unrelated customers. The ratios for those affiliates ranged from 65 percent to 108 percent during the years 1961 through 1964.[10] Based on that information, the project team concluded that petitioner should earn operating income on its sales of Darvon products pur-

[10] The expenses and operating profits, as published, for the four export subsidiaries involved were adjusted by petitioner to better relate intercompany administrative fees to the appropriate sales income. The percentages stated above utilized the adjusted operating figures.

chased from Lilly P.R. equal to 90 to 100 percent of its operating expenses related to the marketing of Darvon products.

The project team recognized that, under its three-step plan for commencing manufacturing operations in Puerto Rico,[11] Lilly P.R. would not begin full manufacturing operations in Puerto Rico immediately, and petitioner would have to sell propoxyphene hydrochloride and other raw materials to Lilly P.R. while its permanent facilities were being constructed. Therefore, the team decided that Lilly P.R. should pay petitioner a price equal to petitioner's standard cost of manufacture, plus 100 percent. The 100-percent markup was chosen to provide petitioner the same markup over costs as it would receive for its marketing functions.

The project team also recognized that petitioner would be providing technical assistance to Lilly P.R. during the transition period while Lilly P.R.'s operations were being established. In June 1965, petitioner had established new procedures for the regular reporting of time spent by petitioner's personnel on Lilly P.R. projects and travel to Puerto Rico on behalf of Lilly P.R., so that the costs of those activities could be charged to Lilly P.R. At the meeting on August 19, 1965, the project team concluded that Lilly P.R. and petitioner should execute a technical assistance agreement pursuant to which Lilly P.R. would reimburse petitioner for its direct costs of providing such assistance.

V. *Lilly P.R.'s Puerto Rican Tax Exemptions*

As stated previously with respect to petitioner's first Puerto Rican study, an industrial tax exemption was granted by the Commonwealth of Puerto Rico to petitioner on May 29, 1963, covering the pharmaceutical manufacture of capsule products. The tax exemption grant was transferred from petitioner to Lilly P.R. effective as of December 14, 1965. The period of that exemption was 10 years, commencing on April 1, 1966.

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[11] As stated earlier, that plan involved (1) the commencement of pharmaceutical manufacturing operations in a leased facility; (2) the establishment of empty capsule manufacturing and pharmaceutical manufacturing in a permanent facility owned by Lilly P.R.; and (3) the establishment of chemical manufacturing on a permanent site, also to be owned by Lilly P.R.

The May 1963 tax exemption grant was the first of six such grants under which Lilly P.R. conducted manufacturing operations in Puerto Rico during the years 1966 through 1973. The second industrial tax exemption, covering the manufacture of empty capsules, was granted to petitioner on August 5, 1965, pursuant to an application filed by petitioner on May 13, 1965. That exemption grant was transferred from petitioner to Lilly P.R. effective as of December 24, 1965. The period of the exemption was 10 years, commencing on January 1, 1968.

A Puerto Rican industrial tax exemption covering the chemical manufacture of propoxyphene hydrochloride and certain other chemicals was granted to Lilly P.R. on October 14, 1966, pursuant to an application filed by Lilly P.R. on March 15, 1966. The period of that exemption was 12 years, commencing on January 1, 1967.

A Puerto Rican industrial tax exemption covering the pharmaceutical manufacture of tablet products was granted to Lilly P.R. on October 17, 1969, pursuant to an application filed by Lilly P.R. on August 15, 1968. The period of the exemption was 10 years, commencing on June 1, 1969. On March 5, 1973, the exemption was amended to include the production of plastic bottles and containers.

A Puerto Rican tax exemption covering the pharmaceutical manufacture of liquid products (i.e., suspensions) was granted to Lilly P.R. on September 17, 1969, pursuant to an application filed by Lilly P.R. on August 15, 1968. The period of that exemption was 10 years, commencing on February 1, 1970.

A Puerto Rican industrial tax exemption covering the chemical manufacture of propoxyphene napsylate and other salts of propoxyphene was granted to Lilly P.R. on October 17, 1969, pursuant to an application filed by Lilly P.R. on August 16, 1968. The period of that exemption was 15 years, commencing on January 1, 1970.

In accordance with the terms of the six Puerto Rican industrial tax exemption grants mentioned above, Lilly P.R. during the years 1966 through 1973 was exempt from Puerto Rican income tax on its qualified income (i.e., income from manufacturing activities), municipal, and commonwealth taxes on real and personal property, license fees, and excise and other municipal taxes. Lilly P.R.'s qualified income included

all income generated by sales of Darvon and Darvon-N products to petitioner.

VI. *Background and Documents Concerning Lilly P.R.*

A. *Organization of Lilly P.R. and Initial Capitalization*

As stated earlier, Lilly P.R. was organized under Indiana law as a wholly owned subsidiary of petitioner on June 9, 1965. Pursuant to the authorization of petitioner's executive committee, Lilly P.R. was initially capitalized with an investment of $1,000 on June 11, 1965, at which time 1,000 shares of Lilly P.R. common stock with no par value were issued to petitioner. By the end of 1965, petitioner had contributed a total of $500,000 cash to the capital of Lilly P.R.

In 1965, Lilly P.R. negotiated a $4.5 million line of credit with the San Juan branch of the Chase Manhattan Bank. Petitioner did not assist Lilly P.R. in those negotiations, nor did it guarantee repayment of any amounts loaned to Lilly P.R. under the line of credit. The purpose of the line of credit was to finance the operations of Lilly P.R. until it commenced the manufacture and sale of products to petitioner. During the years 1965 and 1966, Lilly P.R. borrowed from the Chase Manhattan Bank an aggregate amount of $1,650,000. Lilly P.R. repaid the loans in full by July 1966.

B. *Technical Assistance Agreement*

On April 8, 1966, petitioner and Lilly P.R. executed an agreement entitled "Technical Assistance Agreement," which was effective from January 1, 1966, to December 31, 1975. The execution of that agreement was ratified by Lilly P.R.'s board of directors on April 28, 1966.

In article II of the agreement, petitioner stated that it would, so far as practicable without unreasonable interference with its own business:

> make available [its] scientists, engineers, technicians, research experts, industrial designers and other technical personnel, including if necessary supervisory personnel, for the purpose of providing to [Lilly P.R.] training for its employees and other technical assistance and advice in connection with the manufacture of [Lilly P.R.] products, including the design, construction and operation of factories and other installations, and the installation, operation, and maintenance of the equipment therein.

Article II further provided that petitioner would make its manufacturing facilities available to Lilly P.R. for the training of Lilly P.R. personnel. For the purposes of that agreement, Lilly P.R. products included all products manufactured by Lilly P.R., or which it had a right to manufacture, whether or not manufactured by Lilly P.R. in 1966.

Under article III of the agreement, Lilly P.R. obligated itself to pay petitioner the sum of: (a) The cost to petitioner attributable to the services of its personnel rendering technical assistance to Lilly P.R. in accordance with article II of the agreement, other than engineering services; (b) a technical assistance fee equal to 5 percent of the cost described in (a); and (c) petitioner's standard charge for engineering services performed on behalf of Lilly P.R.

C. *Private Letter Ruling*

On April 7, 1966, petitioner applied to the Service for a ruling that petitioner's proposed assignment to Lilly P.R., as a contribution to capital, of the patents and manufacturing know-how related to propoxyphene and certain other products would qualify for nonrecognition treatment under section 351. The ruling application stated that, because of the current and anticipated demand for certain of its products, petitioner had found it necessary to expand its manufacturing facilities, and that its present plans were to establish full-scale manufacturing facilities in Puerto Rico for Darvon, Darvon-N, and other products. The ruling application notified the Service that during the construction of Lilly P.R.'s permanent manufacturing facilities, Lilly P.R. would purchase its requirements for bulk chemicals from petitioner, but that after such facilities were in operation, Lilly P.R. would manufacture the basic chemicals in Puerto Rico and would no longer purchase such chemicals from petitioner. The ruling application also advised the Service that Lilly P.R. would sell essentially all its finished products to petitioner. Attached to the ruling application were a form of agreement providing for the transfer of the patents and manufacturing know-how from petitioner to Lilly P.R. and a copy of the technical assistance agreement between petitioner and Lilly P.R.

In a letter dated July 20, 1966, petitioner supplied additional information to the Service with respect to its section 351

ruling request and requested a ruling on the source of the income that would be generated by Lilly P.R.'s sales to customers in the United States. In that letter, petitioner described the business reasons for the transfer of patent rights and manufacturing know-how as follows:

> The fundamental business reasons for the transfer of Eli Lilly Patent Rights and Eli Lilly Technology to [Lilly P.R.] is that [petitioner] has decided to vest in [Lilly P.R.] the complete responsibility for the manufacture of the subject products. Since [Lilly P.R.] will have the complete responsibility for manufacturing the subject products it should have the complete right to do so under the Eli Lilly Patent Rights and Eli Lilly Technology. Thus, the business substance which motivates the transfer of rights to [Lilly P.R.] is the fact that these rights will be used exclusively by [Lilly P.R.].
>
> In addition, as mentioned in the request for ruling, the formation of [Lilly P.R.] and the location of manufacturing facilities in Puerto Rico was prompted by [petitioner's] need for additional manufacturing facilities. It should be noted that [petitioner] currently has under active consideration further expansion of its manufacturing facilities in other areas in the United States. The transfer of complete responsibility for the manufacture of the subject products to [Lilly P.R.] will not in any way result in a reduction in the facilities now employed by [petitioner] in the United States. The [Lilly P.R.] facilities will clearly be an expansion of the manufacturing facilities now available to manufacture [petitioner's] products. In this sense, the business motivation was clearly to provide additional manufacturing facilities for [petitioner's] products.

As support for the source of income ruling request, petitioner submitted with that letter the proposed terms of sale for Lilly P.R. sales to petitioner and other U.S. customers.

By a letter dated September 16, 1966, petitioner submitted additional information to the Service regarding the issue of whether the secret processes to be transferred to Lilly P.R. constituted property within the meaning of section 351. Attached to that letter was a memorandum prepared by petitioner's technical personnel which described in detail the secret processes to be transferred to Lilly P.R.

On December 5, 1966, the Service issued the following private letter ruling to petitioner:

> This is in reply to a request for ruling with respect to the Federal income tax consequences of a proposed transaction. Information was submitted in letters dated April 7, July 20, and September 16, 1966. The pertinent facts may be summarized as set forth below.

Eli Lilly and Company ("Lilly"), account number 35-0470950, is an Indiana corporation engaged in the manufacture and sale of pharmaceuticals and related products and agricultural and industrial chemical products.

Due to current and anticipated demand for certain of its drugs, Lilly finds it necessary to establish a plant in Puerto Rico to expand the manufacturing capability for these products. The operation in Puerto Rico will be conducted by Eli Lilly and Company, Inc. ("P.R."), account number 66-0262012, as a wholly owned subsidiary of Lilly. For its contribution of $500,000, Lilly was issued 1,000 shares of no par value common stock of P.R. Additional capital for the purchase of land and the construction of plants will be raised by P.R. by borrowing on its own credit.

P.R. will manufacture Darvon,[12] Dymelor, Valmid and Ultran, which are the trademarks for four of the products presently manufactured and sold in the United States by Lilly. A ten-year tax exemption has been granted in Puerto Rico for the pharmaceutical formulation of two of these products and application will be made for such exemption for the other two drugs.

Lilly proposes to transfer to P.R. as a contribution to capital all right, title and interest in and to U.S. Patents 2,728,779, 2,812,363 and 3,065,261[13] and U.S. patent application 25,209 (relating to Darvon, Dymelor, Ultran and Valmid). In addition Lilly will grant and assign to P.R. the exclusive and perpetual right to use the existing technical information and manufacturing secrets and processes relating to the manufacture and formulation of these products. By these transfers, Lilly will convey to P.R. the exclusive right to make, use and sell under the patents and technical information and to license others to use such patents and technical information upon terms and conditions as P.R. may decide.

The patents to be transferred, except for Ultran, reveal the chemical reactions employed but do not disclose certain steps or the processes utilized in their manufacture in commercial quantities. These processes, which could generally be patented, are maintained as a secret by Lilly and cannot be learned by an analysis of the finished product. They relate to such aspects of manufacture as the solvent employed, the temperature and time duration of certain steps, the use of dangerous reagents in large quantities, the substitution of less expensive chemicals, and methods of recovering certain costly chemicals from the process. The processes employed in the manufacture of Ultran are completely embodied in its patent.

Lilly will transfer to P.R. the technical reports on the processes. However, the manufacture of certain of the products is so complex that Lilly does not believe that a written description will be sufficient to accomplish the desired results. Lilly has therefore transferred to P.R., as a full-time employee, the head of one of its chemical manufacturing plants who was involved as a trouble shooter in these processes. In addition, Lilly has entered into an agreement with P.R. on April 8, 1966, under which Lilly will assist P.R. in the establishment of manufacturing facilities in Puerto Rico and render technical assistance, to the extent requested, in connection with the manufacture of the products. P.R. will reimburse Lilly for all costs incurred

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[12] The Service and petitioner both use "Darvon" to include Darvon and Darvon-N products.

[13] Patent 3,065,261 is the napsylate patent, not the patent relating to Ultran®

plus five percent and will pay for engineering services on the basis of Lilly's standard charges for such services.

P.R. will manufacture the products in Puerto Rico. Other than what may be sold in Puerto Rico to related and unrelated parties, the products will be sold to Lilly in Puerto Rico for trans-shipment to the Unites States and resale by Lilly in the ordinary course of its business. The sales by P.R. will be in accordance with a statement of conditions of sale which accompanied the request for ruling and is incorporated in this ruling letter by reference.

Lilly does not intend to cause P.R. to sell or license any of the patent rights or technology to third parties. Lilly intends to operate P.R. as a subsidiary and has no intention of selling or otherwise disposing of the stock of P.R.

Based solely on the information submitted, it is held as follows:

(1) No gain or loss will be recognized to Lilly upon the transfer to P.R. as a contribution to capital of all substantial rights to the patents, patent application, secret processes and technology relating to the manufacture of Darvon, Dymelor, Ultran and Valmid (section 351).

(2) The basis of the stock of P.R. in the hands of Lilly will include the adjusted basis of the property transferred (section 358(a)(1)).

(3) Based on the assumption that P.R. will be established and operated in accordance with the above representations, and that the sale of its products will be made in the manner indicated, the gross income realized by P.R. from the manufacture and sale of pharmaceutical products to Lilly and other United States purchasers will constitute gross income from sources within a possession of the United States within the meaning of section 931(a)(1) of the Code.

No opinion is expressed as to the possible application of section 482 in the event it is subsequently determined that the amounts to be paid by P.R. for the technical assistance to be provided by Lilly does not represent adequate consideration for such assistance or as to whether part of the stock of P.R. was, in fact, received by Lilly for such assistance.

No opinion is expressed as to the tax treatment of the transaction under the provisions of any of the other sections of the Code and Regulations which may also be applicable thereto or to the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction which are not specifically covered by the above rulings.

A copy of this ruling should be attached to the Federal income tax returns of the taxpayers involved for the taxable year in which the transaction is consummated.

D. *Assignment of Patents and Manufacturing Know-How*

On December 5, 1966, in accordance with the private letter ruling issued to petitioner on that date, petitioner and Lilly P.R. entered into an agreement entitled "Assignment of Patents and Related Technical Data." That agreement provided as follows:

THIS AGREEMENT, made the 5th day of December, 1966, by and between ELI LILLY AND COMPANY, a corporation organized and existing under

and by virtue of the laws of the State of Indiana, with offices at 740 South Alabama Street, Indianapolis, Indiana (hereinafter referred to as "ELI LILLY"), and ELI LILLY AND COMPANY, INC., a corporation organized and existing under and by virtue of the laws of the State of Indiana, with offices at 301 East McCarty Street, Indianapolis, Indiana (hereinafter referred to as "P.R."),

WITNESSETH:

WHEREAS, ELI LILLY is engaged in the business of manufacturing and selling pharmaceutical and biological products, and

WHEREAS, ELI LILLY in the course of its operations in the United States has acquired certain technical data, consisting principally of reports, drawings, specifications, blueprints, written descriptions of manufacturing processes, and production information with respect to the manufacture of its Darvon® product line and related product lines, including combinations, and

WHEREAS, ELI LILLY has obtained two United States patents relating to its Darvon® product line, and

WHEREAS, ELI LILLY is willing to grant P.R. the exclusive right to use such technical data in conjunction with an assignment of such patents, and

WHEREAS, P.R. has been formed to conduct the manufacture of the Darvon® line of products for sale in the United States market, and

WHEREAS, P.R. desires to acquire said patents and technical data from ELI LILLY as a contribution to its share capital:

NOW THEREFORE

In consideration of the mutual promises and covenants herein contained, the receipt and sufficiency of which are hereby acknowledged, it is understood and agreed by and between the parties as follows:

ARTICLE I

ELI LILLY hereby assigns to P.R. all right, title and interest in and to U.S. Patents 2,728,779 [the propoxyphene patent] and 3,065,261 [the napsylate patent]. By such grant, ELI LILLY conveys to P.R. the exclusive right to make, use and sell under said patents for their full lives and any extensions or renewals thereof, and to license others to use the same upon such terms and conditions as P.R. may decide. ELI LILLY agrees to execute any documents and authorizations which may be legally required to enable the use of said patents by P.R.

ARTICLE II

Eli Lilly hereby assigns and grants to P.R. the exclusive and perpetual right to use and to license others to use the existing technical information and manufacturing secrets and processes of Eli Lilly relating to the manufacturing and formulation of its Darvon® product line within the United States and Puerto Rico. By said grant Eli Lilly conveys to P.R. the exclusive and perpetual rights to make, use and sell under said technical data and to license others to use the said technical data upon such terms and conditions as P.R. may decide.

ARTICLE III

In consideration for the rights, titles and interests set forth in Articles I and II above, P.R. agrees to receive said patents and related technical data as additional consideration for P.R.'s stock which has already been issued to Eli

Lilly and to reflect in its corporate records said patents and technical data as contributions to share capital provided by Eli Lilly.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be signed and sealed by their duly authorized officers at the places and on the dates set forth below.

ELI LILLY AND COMPANY

By: (S) BURTON E. BECK
Executive Vice President

Signed and sealed at
Indianapolis, Indiana
this 5th day of December, 1966.

(S) C. H. BRADLEY, JR.
Attest

ELI LILLY AND COMPANY, INC.

By: (S) W. B. FORTUNE
Chairman of the Board of Directors

Signed and sealed at
Indianapolis, Indiana
this 5th day of December, 1966.

(S) WALTER C. TAYLOR, JR.
Attest

The December 1966 Assignment of Patents and Related Technical Data contained the same terms as the form of assignment attached to petitioner's ruling request dated April 7, 1966. On December 19, 1966, petitioner's board of directors ratified the assignment to Lilly P.R., as a contribution to capital, of the propoxyphene patent, the napsylate patent, and the related manufacturing know-how. On the same date, Lilly P.R.'s board of directors ratified the acceptance of that assignment. The Assignment of Patents and Related Technical Data was recorded in the U.S. Patent Office on February 14, 1969.

In December 1966, immediately after the execution of the Assignment of Patent Rights and Related Technical Data, petitioner ceased performance of step 6 of the propoxyphene hydrochloride manufacturing process. During the phase-in of Lilly P.R.'s chemical manufacturing facility in 1967, petitioner continued to produce dextro carbinol base (steps 1 through 5)

for sale to Lilly P.R. Petitioner did not perform any of the steps in the production of propoxyphene hydrochloride after 1967.

E. *Distribution Agreements*

In accordance with the decisions made in 1965 and 1966 by petitioner's project team that the distribution of Lilly P.R.'s products would be made through petitioner's U.S. marketing organization, petitioner and Lilly P.R. entered into a "Distribution Agreement," effective as of January 1, 1966. In that agreement, Lilly P.R. appointed petitioner its nonexclusive distributor for the sale of Darvon products throughout the world. The distribution agreement provided that: (a) Petitioner would purchase all its requirements for Darvon products from Lilly P.R. and would promote those products through its marketing organization; (b) Lilly P.R.'s selling price to petitioner for each of the Darvon products was equal to petitioner's net wholesale price[14] for such product less a 35-percent discount; (c) petitioner was entitled to charge back to Lilly P.R. (i.e., receive rebates from Lilly P.R.) 25 percent of the net wholesale prices of Darvon products sold by petitioner to U.S. Government agencies or exported by petitioner from the United States; (d) petitioner would make payments to Lilly P.R. within 180 days after the dates of Lilly P.R.'s invoices; (e) Lilly P.R. would supply reasonable quantities of Darvon products to petitioner at no charge for use by petitioner as samples; and (f) the agreement was for a term of 5 years, cancelable by either party upon 90 days' notice. The provisions of the distribution agreement regarding the place of sale and passage of title of the products were the same as the terms of sale submitted to the Service as support for petitioner's source of income ruling request in its letter to the Service dated July 20, 1966.

As of January 1, 1971, petitioner and Lilly P.R. entered into a new "Distribution Agreement," which superseded the 1966 distribution agreement. The terms and conditions of the 1971 agreement were the same as in the 1966 agreement, except that it provided that: (a) Lilly P.R.'s selling prices to petitioner for Darvon products were equal to petitioner's net wholesale

[14] "Net wholesale price" refers to petitioner's price to drug wholesalers for a particular product. During the years 1965 through 1973, net wholesale prices were determined by discounting petitioner's "net trade prices," which were its suggested prices to retail pharmacies, by 17 percent.

prices less 45 percent; and (b) petitioner was entitled to chargebacks on Government and export sales of 15 percent of petitioner's net wholesale prices.

During the years 1971 through 1973, petitioner and Lilly P.R. executed 9 amendments to the 1971 distribution agreement. In general, those amendments added new products (e.g., Darvon-N) to be sold by Lilly P.R. to petitioner, modified the selling prices of products sold by Lilly P.R. to petitioner,[15] and provided that, effective January 1, 1973, Lilly P.R. would supply petitioner with Darvon and Darvon-N products for use as samples at Lilly P.R.'s cost. The selling prices as applicable to the years before us will be discussed at length in a later portion of our findings.

F. *Joint Research Agreement*

Although the technical assistance agreement between petitioner and Lilly P.R. was sufficiently broad to cover research and development activities performed by petitioner for Lilly P.R., petitioner's research and development expenses related to propoxyphene products were not billed to Lilly P.R. pursuant to that agreement. In 1968, petitioner determined that those research and development expenses should be charged to Lilly P.R., so it entered into an agreement with Lilly P.R. entitled "Joint Research Agreement." The agreement was retroactively effective to January 1, 1967, and had a term of 7 years ending on December 31, 1973.

In pertinent part, the joint research agreement, provided as follows:

ARTICLE I.

RESEARCH COMMITMENTS

Section 1.1. [Petitioner] hereby agrees to undertake projects on behalf of [Lilly P.R.] and to arrange for clinical trials and all related activities in connection with the development and testing of the pharmaceutical and biological products.

Section 1.2. [Petitioner] agrees to undertake research, development and related activities under this Agreement only to the extent that—

(a) [Petitioner's] facilities and personnel permit, without interfering with [petitioner's] own research and development progress, the undertaking of

[15] See also pp. 1074–1076.

such activities without requiring any significant capital expenditures for alteration of [petitioner's] existing research and development facilities;

(b) [Petitioner] has complete control over the scheduling of any such activities within its research and development facilities;

(c) [Petitioner] does not become liable or responsible for the results of any such research and development activities.

ARTICLE II

CONSIDERATIONS

Section 2.1. The parties agree that [Lilly P.R.] shall have the exclusive and perpetual right to use any of the data developed by [petitioner] under the terms of this Agreement (including any items of a patentable nature and any patents which may issue thereon) within the United States and the Commonwealth of Puerto Rico and that [petitioner] will have the exclusive and perpetual right to use any of the data developed under the terms of this Agreement (including any items of a patentable nature and any patents which may issue thereon) in all areas of the world outside of the United States and the Commonwealth of Puerto Rico.

Section 2.2. [Lilly P.R.] agrees to pay [petitioner] the cost of any research, development and clinical trials undertaken by [petitioner] at the request of [Lilly P.R.] under this Agreement.

Section 2.3. The cost of the research, development, and clinical trials undertaken by [petitioner] for [Lilly P.R.] shall be determined for the purpose of this Agreement in accordance with accounting practices which are consistent with sound accounting principles generally accepted in the United States. Without in any way limiting the foregoing, it is understood that such "research expenses" shall include the following expenses:

2.31. Salaries and wages of all employees working full time on such activities.

2.32. The cost of employee benefits pertaining to such employees.

2.33. Research grants.

2.34. The fees of research consultants.

2.35. The costs of biochemical analyses, chemical analyses, clinical expense, and all veterinary testing relating to such activities.

2.36. Cost of chemicals, accessories, glassware, and other supplies used directly in such activities.

2.37. Legal and other expenses spent in connection with obtaining and maintaining patents covered by this contract or in connection with patent interference proceedings related thereto.

2.38. Communication and travel costs, including stationery, postage, cable, phone, and travel expenses of [petitioner's] personnel when such expenditures are in connection with [petitioner's] research, development, and clinical trials for [Lilly P.R.].

2.39. Depreciation or amortization of capital items used in such activities.

2.391. Any other expenses of occupancy and general administration appropriately attributable to such activities.

Section 2.4. [Petitioner] will submit to [Lilly P.R.] twice annually its statement of expenses incurred under the terms of this Agreement, and [Lilly P.R.] agrees to make payment thereof in United States dollars within thirty (30) days after receipt of each such statement.

C. *Agreements Regarding Empty Capsules*

In a license agreement dated January 1, 1968, petitioner granted Lilly P.R. a nonexclusive license to make, use, and sell empty capsules covered by two U.S. patents owned by petitioner. Under that license, Lilly P.R. was obligated to pay petitioner a royalty of 5 cents per 1,000 commercially acceptable empty capsules manufactured by Lilly P.R. and covered by either of the two patents. The agreement provided that it would terminate upon the expiration of both of the licensed patents or 30 days after either party gave written notice of termination to the other party.

During the years 1970 through 1973, petitioner and Lilly P.R. entered into three agreements pursuant to which Lilly P.R. manufactured and sold empty capsules to petitioner.

VII. *Lilly P.R.'s Manufacturing Activities*

A. *Temporary Leased Facility*

In May 1965, and pursuant to the May 5, 1965, resolution of petitioner's board of directors approving the establishment of manufacturing operations in Puerto Rico, petitioner entered into a lease with Valencia Realty Corp. for 67,000 square feet of floor space on two floors in a new five-story building located in the Valencia section of San Juan, Puerto Rico. Petitioner's interest in that lease was assigned to Lilly P.R. in June 1965.

On August 5, 1965, a contract was executed between Lilly P.R. and a Puerto Rican construction company calling for the modification of the leased premises to accommodate the pharmaceutical manufacture of Lilly P.R.'s products. The first floor of the leased facility was used for office and warehouse space. The fifth floor was used to perform the pharmaceutical manufacture of Lilly P.R.'s products. In addition, Lilly P.R. installed air-conditioning, dehumidification, dust-collection, and power equipment on the roof of the facility.

Pharmaceutical manufacturing operations became completely operational at the Valencia facility in January 1966.

Prior to that time, pilot runs were made at that facility to test equipment and to train personnel.

During 1966, the pharmaceutical manufacture of Darvon products was performed both by Lilly P.R. in Puerto Rico and by petitioner in Indiana. By the end of 1966, petitioner had discontinued all pharmaceutical manufacturing operations for Darvon products with the exception of certain sample packaging operations. During the years 1967 through 1973, the entire pharmaceutical manufacturing process for Darvon and Darvon-N products was performed by Lilly P.R., except for certain sample packaging and, during the years 1968 through 1973, Identi-dose®[16] packaging of Darvon and Darvon-N products, which was performed or contracted by petitioner.

The Valencia site was designed to serve as a temporary facility while permanent facilities were under construction.

B. *Carolina Facility*

In May 1965, petitioner entered into an agreement to purchase approximately 13 acres of land in an industrial park in Carolina, Puerto Rico, to be used as the site for Lilly P.R.'s permanent pharmaceutical manufacturing facilities. At a meeting on December 14, 1965, Lilly P.R.'s board of directors approved the acceptance of the assignment of that purchase agreement from petitioner.

In June 1965, Lilly P.R. entered into an agreement with a Puerto Rican architectural firm for the performance of architectural and engineering work in connection with the design and development of the Carolina plant. Construction of the Carolina facility started on September 1, 1966.

The manufacture of empty capsules was begun at the Carolina facility in October 1967. The period between October 1, 1967, and January 1, 1968, was a shakedown period but some marketable products were produced. As of January 1, 1968, Lilly P.R.'s investment in capsule manufacturing machinery and equipment was $1,499,739. At the time that empty capsule production was begun, approximately 92,000 square feet of the Carolina facility were completed, consisting of the common service building (the powerhouse), the warehouse, and the empty capsule manufacturing department.

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[16] "Identi-dose" was petitioner's trademarked name for its individual dosage from packages of Darvon and Darvon-N products.

Pharmaceutical manufacturing operations were completely operational at the Carolina facility by May 15, 1968. At that time, the facility occupied approximately 175,000 square feet, divided functionally as follows:

	Square feet
Common services	19,000
Warehouse	40,000
Empty capsule manufacturing department	33,000
Office building	17,000
Capsule filling	50,000
Capsule finishing	16,000
Total	175,000

As of June 1, 1968, the total investment in pharmaceutical manufacturing operations at Carolina was $2,468,462, of which $568,327 represented direct production equipment and $1,900,135 represented supportive equipment. As of June 1, 1968, the total cost of the Carolina facility was $8,917,499, of which $531,276 was invested in land, $5,037,098 in buildings, and $3,349,125 in machinery and equipment. An additional $619,075 of machinery and equipment transferred from the Valencia operation was also used at the Carolina facility.

C. *Mayaguez Facility*

At a meeting on January 20, 1966, Lilly P.R.'s board of directors authorized the officers of that company to select a plant site in Puerto Rico for Lilly P.R.'s chemical manufacturing facility and to develop plans and cost estimates for that facility. After the meeting, Lilly P.R.'s officers began looking for sites for the proposed chemical manufacturing plant with the assistance of the Puerto Rican government. After negotiations with more than one government agency, Lilly P.R. obtained the necessary government approvals to build a plant at a site in Mayaguez, Puerto Rico, at the western end of the island. In June 1966, Lilly P.R. purchased a 25-acre site in Mayaguez.

Construction of the Mayaguez facility was started in August 1966, pursuant to contracts between Lilly P.R. and a Puerto Rican construction firm. The construction of the Mayaguez plant was completed in October 1967.

The performance of step 6 (propoxyphene hydrochloride) in the production of bulk propoxyphene hydrochloride was start-

ed at Lilly P.R.'s Mayaquez facility in December 1966, subsequent to the execution on December 5, 1966, of the Assignment of Patents and Related Technical Data. Lilly P.R. began production of step 1 in August 1967, step 2 in September 1967, and steps 3, 4, and 5 in October 1967.

In December 1966, when production of step 6 began, the Mayaquez facility occupied approximately 14,340 square feet as follows:

	Square feet
Building 1, office building	3,840
Building 2, warehouse	7,000
Building 3, manufacturing	3,500
Total	14,340

Upon completion of the Mayaguez facility in October 1967, the following additional structures were utilized in the manufacturing operation:

	Square feet
Building 4, sewage plant	1,600
Building 5, fire pump house	900
Building 6, major manufacturing building	24,000
Building 7, warehouse	10,000
Tank farm consisting of eighteen 12,000 gallon tanks	30,000
Total	66,500

The total amount invested in the Mayaguez chemical facility as of October 1, 1967, was $6,192,257, of which $302,316 was invested in land, $2,708,028 in buildings, and $3,181,913 in machinery and equipment. During the years 1969 through 1973, the manufacturing capacity of both the Mayaguez and Carolina facilities of Lilly P.R. was substantially expanded. Construction of additional facilities for the manufacture of propoxyphene napsylate at Lilly P.R.'s Mayaguez facility began in 1969 and was completed in 1970 at a total cost of approximately $1 million. As of December 31, 1973, Lilly P.R.'s total investment in physical facilities was $25,404,782, of which $978,756 was invested in land, $13,945,669 in buildings, and $11,480,357 in machinery and equipment.

D. *Personnel*

1. *Organization of Initial Work Force*

The initial management of Lilly P.R. consisted of five former employees of petitioner who moved to Puerto Rico to become

permanent employees of Lilly P.R. One of the principal assignments of that management team was to train the Puerto Rican work force of Lilly P.R. and to develop Puerto Rican employees capable of taking over the management of Lilly P.R.

Soon after the management team arrived in Puerto Rico, it began the process of interviewing and employing Puerto Ricans to staff the temporary facility at Valencia. The team worked closely with the Puerto Rican Employment Service, a government agency which screened all applications to determine which applicants were best qualified to meet the job descriptions supplied by Lilly P.R., and performed background checks and applicant health examinations. By January 1966, Lilly P.R. employed 56 Puerto Ricans; by January 1968, Lilly P.R. employed over 400 Puerto Ricans. The hiring of those employees was accomplished without petitioner's assistance. When Lilly P.R.'s pharmaceutical manufacturing operations were transferred from Valencia to Carolina in 1968, all the employees at the Valencia facility moved to the Carolina facility.

2. *Training of Employees*

At the beginning of Lilly P.R's operations in Valencia, small teams of petitioner's employees traveled to Puerto Rico, at the request of Lilly P.R., for 2 or 3 weeks at a time to assist in the training of the employees at that facility. The teams were small, less than 10 in number, because Lilly P.R.'s management team was experienced in production, and because Lilly P.R. rapidly developed a group of Puerto Rican employees who were capable of assisting in the training function.

The training of the work force at Lilly P.R.'s Mayaguez facility required more assistance from petitioner because the chemical manufacturing process for propoxyphene hydrochloride was complicated and dangerous, and because employees in the Mayaguez area generally were less fluent in English than those in the San Juan area. Consequently, 12 to 14 of petitioner's chemical manufacturing employees were residents in Mayaguez for a period of from 6 to 12 months to train Lilly P.R.'s Puerto Rican chemical manufacturing operators.

In 1968, because the work force at the Valencia facility had over 2 years' experience in the pharmaceutical manufacture of

Lilly P.R.'s products, and because the entire work force moved from Valencia to the Carolina facility in that year, Lilly P.R. did not require any great amount of assistance from petitioner in training its employees at the Carolina facility.

3. *Board of Directors, Officers, and Management Committees*

During the years 1965 through 1973, Lilly P.R.'s board of directors consisted of from 9 to 11 individuals. Throughout that period, two of the directors were management employees, the general manager and treasurer, of Lilly P.R. living in Puerto Rico. The remaining members of Lilly P.R.'s board of directors were officers and/or employees of petitioner.

During the years 1965 through 1973, Lilly P.R. had an executive committee, which had 5 members through 1972 and 6 members in 1973. During the years 1971 through 1973, Lilly P.R. also had the following committees: operations, salary, budget, safety and housekeeping, and benefits and retirement.

During the years 1971 through 1973, Lilly P.R.'s general manager had authority to approve capital expenditures of less than $1,000; the operations committee had authority to approve capital expenditures of less than $5,000; the executive committee had authority to approve capital expenditures of less than $25,000; Lilly P.R.'s board of directors had the authority to approve capital expenditures of between $25,000 and $50,000; and proposed capital expenditures in excess of $50,000 were submitted for approval to petitioner's executive committee or board of directors. The division of authority for the approval of capital expenditures was the same as that followed by every other domestic and foreign subsidiary of petitioner.

4. *1971–73 Lilly P.R. Personnel*

During the years 1971, 1972, and 1973, Lilly P.R. had a total of 608, 612, and 651 employees, respectively. During that period, all employees below the management level were Puerto Rican.

During the years 1971, 1972, and 1973, Lilly P.R. had 22, 25, and 23 management employees, respectively. In 1971, 15 of those management employees were Puerto Ricans.

E. *Manufacturing Activities 1971–73*

1. *Production Planning*

The planning and scheduling of Lilly P.R.'s manufacturing operations were conducted in Puerto Rico by employees of Lilly P.R. without the assistance of petitioner. Lilly P.R.'s production planning process involved the scheduling of raw material purchases and the scheduling of production on a day-to-day basis consistent with Lilly P.R.'s policy of keeping a stable and fully occupied work force.

Petitioner's finished stock planning department in Indianapolis provided Lilly P.R. with annual projections of the quantities of each package size of each product that petitioner would purchase from Lilly P.R. during the coming year.[17]

From the annual projections, Lilly P.R.'s production planning group at the Carolina facility prepared production schedules for the pharmaceutical manufacture of the finished products to be sold to petitioner, and determined the quantities of propoxyphene hydrochloride and propoxyphene napsylate necessary to manufacture those products. Based upon the production schedule, the empty capsule manufacturing manager produced a schedule for the manufacture of empty capsules. Also, materials-purchasing personnel determined whether and when to purchase raw materials for the empty capsule manufacturing operation based upon inventory levels of materials on hand.

The projections of annual requirements for propoxyphene hydrochloride and propoxyphene napsylate prepared at Carolina were sent to the Mayaguez facility and used as the starting point for its production planning. Personnel at Mayaguez determined the quantities of intermediate chemicals necessary to produce the final chemicals and projected the amount of basic raw materials needed during the year. The purchasing department of Mayaguez issued purchase orders throughout the year based upon the projected requirements for raw materials.

2. *Chemical Manufacturing at Mayaguez*

During the years 1971 through 1973, propoxyphene hydrochloride and propoxyphene napsylate were manufactured in bulk form at Lilly P.R.'s Mayaguez facility and transported to Lilly P.R.'s Carolina facility for use in the pharmaceutical

[17] Petitioner's projected product needs were updated on a monthly basis and, if sales were moving faster than anticipated, changes in product needs were communicated to Lilly P.R. by telephone.

manufacture of Darvon and Darvon-N products. The chemical manufacturing processes at the Mayaguez facility involved numerous continuous reactions, and as a result, that facility was generally operated 24 hours per day, 5 days per week. The manufacturing activities at Mayaguez were conducted according to a campaigning program. For example, a 2-week campaign might have been conducted to build up stock of propiophenone (step 1) which was then used during a subsequent 2-week campaign to produce iso butyro phenone derivative (step 2).

Each of the steps in the manufacturing process was covered by a separate manufacturing ticket (manufacturing tickets are defined in section F under this heading, *infra*), and generally was performed independently of the other steps. Although each step took only 1 to 3 days to complete, in the normal sequence of operations at Mayaguez, an entire series of campaigns from the beginning (step 1) to the end (step 6) took approximately 60 to 90 days to complete.

The chemical manufacturing processes performed by Lilly P.R. at the Mayaguez facility were complicated. Each of the 6 steps in the production of propoxyphene hydrochloride and propoxyphene napsylate was in itself a multistep process requiring the utilization of approximately 28 reaction tanks and the services of approximately 35 operators, working on a three-shift basis. The processes involved the use of highly corrosive and flammable chemicals, and as a result, Lilly P.R.'s operators wore acid goggles, air line respirators, and rubber gloves while handling those chemicals. Most of the chemical reactions involved in the processes had to be performed within narrow ranges of variables such as temperature and quantity. For example, if too little heat was applied to the reaction of propionic anhydride and dextro carbinol base in the final step of producing propoxyphene hydrochloride, some of the dextro carbinol base would remain in the propoxyphene base as a contaminant. If too much heat was applied to that reaction, the propoxyphene base was decomposed. The operators were required to exercise judgment during the manufacturing processes, such as using a sight glass to determine whether separations of solutions had been made. Operators also were required to perform temperature and pH tests during the processes.

Lilly P.R.'s operators involved in the manufacturing processes at Mayaguez were all at least high school graduates. As a result of the complexity of the manufacturing processes, it generally took an operator 1 year to learn the skills necessary to perform properly all the procedures involved in only one of the 6 steps. It was not necessary, however, for each operator to be familiar with every step in order for the processes to function properly.

The intermediate chemicals produced at Mayaguez in steps 1 through 4 were analyzed in the plant laboratory and subjected to as many as 8 quality control tests. Steps 5 and 6 were performed as one continuous process, during which samples were taken to the laboratory for analysis. The final product, propoxyphene hydrochloride or propoxyphene napsylate, was subjected to 28 quality control tests lasting a period of 2 days. After satisfactory completion of the quality control tests, the finished product was shipped to the Carolina facility in accordance with that facility's request for bulk chemicals.

3. *Pharmaceutical Manufacturing at Carolina*

During 1971, 1972, and 1973, Lilly P.R.'s Carolina facility was engaged in the pharmaceutical manufacture of Darvon and Darvon-N products. Its manufacturing operations were divided into the manufacture of empty capsules, the formulation and encapsulation or tableting of the mixed material,[18] and the packaging and labeling of the finished products.

Lilly P.R.'s empty capsule manufacturing department operated 24 hours a day, 7 days a week, and employed approximately 65 to 80 people. The manufacturing process involved the mixture of gelatin melts, using protocols (similar to manufacturing tickets, see pages 1046–1048) prepared and issued by Lilly P.R., and the actual production of the empty capsules on the capsule manufacturing machines. The empty capsules were tested throughout the manufacturing process to ensure the absence of physical defects and bacteria. The capsules passing those tests were stored for later use in Lilly P.R.'s pharmaceutical manufacturing operations.

The pharmaceutical manufacture of capsule products at Carolina entailed mixing the raw chemical materials and

[18]The Carolina facility also manufactured one small volume propoxyphene liquid product, Darvon-N Suspension.

filling the empty capsules with the mixed, or formulated, materials. For the manufacture of tablet products, the dry chemical ingredients were mixed with a lubricant, compressed by machine into tablets, and coated with a colored material. The products were periodically tested and analyzed for physical defects, weight, and the amount of active ingredients.

The finished capsules and tablets were moved to the finishing department, where they were counted and filled into plastic bottles, 10 bottles at a time. The bottles were capped, labeled, and packaged in corrugated boxes for shipment to Indianapolis.

The entire pharmaceutical manufacturing process for capsule products normally took approximately 1 month per lot. The filling operation, alone, took approximately 10 days per lot on a two-shift operation. Approximately 150 to 175 employees were involved in the production process, although at any one time, as few as 15 people might have been working on a particular lot. The pharmaceutical manufacture of tablet products, because of the additional steps of mixing the ingredients with liquids and coating, required approximately 1½ to 2 months per lot to complete.

F. *Manufacturing Tickets and Related Procedures*

A manufacturing ticket is a document listing the step-by-step procedures for manufacturing one lot of a specific pharmaceutical product. A separate manufacturing ticket was issued by petitioner for each lot of each chemical intermediary and final bulk chemical product manufactured by Lilly P.R. at its Mayaguez facility and for each finished product manufactured at its Carolina facility. The manufacturing tickets, in essence, were oversized recipes listing the names and quantities of all of the ingredients to be used in the manufacturing process, the step-by-step actions required to combine them in perfect order, and the specifications for the final product produced under the manufacturing ticket. They specified the checks and audits to be carried out by production workers and by quality control personnel, as well as the tests to be conducted at critical points by laboratory scientists. Manufacturing tickets for chemical manufacturing processes also indicated temperatures, pressures, and reaction times for the chemical reactions covered by those manufacturing tickets.

The manufacturing tickets were numbered to correspond with given lots of the product and were initialed by the operators of Lilly P.R. responsible for each step in the various manufacturing processes so that any problem that arose with respect to a lot could be traced back to the operators involved. FDA regulations required the use of documents such as manufacturing tickets to provide control and accountability in the manufacture of pharmaceutical products. The manufacturing ticket procedures used by petitioner and Lilly P.R. satisfied that FDA requirement, although manufacturing tickets were used by petitioner even before such documents were required by the FDA.

During the years 1966 through 1973, the manufacturing tickets used by Lilly P.R. in its manufacturing processes were issued to Lilly P.R. by petitioner's ticket issuance department in Indianapolis, Indiana. The ticket issuance department was the custodian of the master formula for each product manufactured by petitioner and Lilly P.R. The ticket issuance department produced duplicates of the master formulas using a large[19] copying machine pursuant to instructions from petitioner's finished stock planning department that tickets were needed by Lilly P.R.'s Carolina facility or upon receiving requests for tickets from Lilly P.R.'s Mayaguez facility. The ticket issuance department assigned the lot number to each manufacturing ticket and produced tags or stickers called manufacturing tags which bore the lot number and were to be placed on containers to identify raw and work-in-process materials to that lot. The manufacturing tags, required by FDA regulations, were sent to Lilly P.R. along with the manufacturing tickets for the lot. After the manufacturing tickets were used by Lilly P.R. in its chemical and pharmaceutical manufacturing processes, they were returned to petitioner's ticket issuance department in Indianapolis for microfilming and storage.

The manufacturing tickets used by Lilly P.R. for the production of Darvon products were essentially the same as those developed by petitioner prior to 1967 for use in its manufacture of those products. The manufacturing tickets for Darvon-N products were developed jointly by petitioner and

[19]The master formula and manufacturing ticket for a product were often as long as 15 feet.

Lilly P.R. The master manufacturing tickets for Darvon and Darvon-N products were modified from time to time, based upon recommendations by employees of Lilly P.R. Generally, those modifications were made to remedy a problem or implement improved manufacturing procedures developed by Lilly P.R.

During the years 1971 through 1973, Lilly P.R. personnel recommended approximately 55 modifications of the manufacturing tickets for Darvon and Darvon-N products, 2 of which were the subject of a supplemental NDA. (See pages 1067–1068.) All the manufacturing ticket modifications recommended were adopted, even though there were some comments by petitioner that resulted in further testing by Lilly P.R. prior to their adoption.

In addition to the manufacturing tickets, Lilly P.R., during the years in issue, used master packaging orders issued by petitioner's ticket issuance department in Indianapolis. Those master packaging orders were used by Lilly P.R.'s Carolina facility to produce the packaging orders it used in the packaging of Darvon and Darvon-N products.

During the years 1971, 1972, and 1973, Lilly P.R. also used numerous written procedures (called protocols) that had been developed by Lilly P.R. to cover manufacturing and other activities that were not covered by manufacturing tickets or packaging orders. For example, the Mayaguez facility of Lilly P.R. developed protocols to cover the reworking of chemicals it produced that did not meet specifications, and the Carolina facility developed standard procedures for the preparation of gelatin solutions. Both the Mayaguez and Carolina facilities developed procedures that covered virtually every aspect of their operations, including administrative and financial functions. In this respect, Lilly P.R. had the use of numerous manuals prepared by petitioner in its manufacturing and other operations.

G. *Raw Material Purchases*

During the years 1968 through 1973, Lilly P.R.'s chemical and pharmaceutical manufacturing activities respectively required the use of approximately 35 and 140 different raw materials. Lilly P.R.'s established policy was to purchase most of its raw materials from unrelated suppliers located in Puerto

Rico; to purchase raw materials from unrelated suppliers located outside of Puerto Rico if Puerto Rican suppliers could not be located; and to purchase raw materials from petitioner only in rush situations, when it had trouble locating or obtaining materials from another source, or when petitioner was the only source. Lilly P.R.'s purchases of raw materials from third-party suppliers accounted for 80 percent, 81 percent, and 87 percent of its total raw material purchases in dollars for 1971, 1972, and 1973, respectively. The remainder of Lilly P.R.'s purchases of raw materials in those years were from petitioner. Among the purchases of materials from petitioner were all labels and literature used by Lilly P.R. for its Darvon and Darvon-N products.

Although petitioner provided Lilly P.R. with a list of suppliers of raw materials, Lilly P.R. was not required to purchase only from the suppliers on the list. During the years in issue, Lilly P.R. selected and evaluated its suppliers of raw materials without petitioner's assistance.

H. *Equipment Purchases*

During the years 1965 through 1973, Lilly P.R. purchased equipment and machine parts either directly from third party suppliers or through petitioner. The procedures for those purchases are discussed in detail at pages 1099–1100.

Although equipment purchases by Lilly P.R. in excess of $50,000 were submitted to petitioner's executive committee or board of directors for approval, none of Lilly P.R.'s requests for authorization to purchase equipment was rejected during the years 1965 through 1973.

I. *Technical Assistance*

During the years 1971, 1972, and 1973, Lilly P.R. received and paid for certain technical assistance from petitioner under the technical assistance agreement. Such assistance included the following:

a. Installation of new chemical and pharmaceutical manufacturing equipment, and instruction relative to the use of said equipment;
b. Maintenance and repair of chemical and pharmaceutical manufacturing equipment;
c. Managerial assistance relative to industrial health programs;
d. Expert industrial relations assistance;
e. Consultations with personnel relative to Lilly P.R.'s Credit Union;

f. Expert assistance relative to the engineering and long term planning of manufacturing operations;

g. Expert assistance and coordination with public officials relative to waste treatment and the environmental impact of facilities;

h. Expert assistance relative to financial organization, payroll accounting and computerization of data;

i. Training in the areas of laboratory testing, accounting and managerial skills;

j. Assistance with problems in quality control laboratory;

k. Review of inventories and assistance in inventory planning;

l. Maintenance of Lilly P.R. aircraft;

m. Supervision of telephone communication system installation; and

n. Assistance in cafeteria and food service operations.

Petitioner provided technical assistance to Lilly P.R. only upon request. Lilly P.R. was free to and did retain unrelated outside consultants and advisers having mechanical, electrical, architectural, accounting, and legal expertise.

J. Quality Control

In the normal course of its operations, Lilly P.R. performed all required quality control tests on raw materials and in-process materials without the need for assistance from or coordination with petitioner. With one exception, Lilly P.R. also normally performed all quality control tests on finished products. Lilly P.R.'s Mayaguez facility did not have the capability to perform toxicity tests on the final products, bulk propoxyphene hydrochloride and bulk propoxyphene napsylate. That testing was performed on samples of the products by petitioner's quality assurance department in Indianapolis, Indiana.

While petitioner did not routinely perform quality control tests on materials and products of Lilly P.R., it did perform a limited number of quality control tests at the request of Lilly P.R. For example, if Lilly P.R. encountered problems in performing a particular quality control test, it might have had petitioner perform the same test in order to compare results. The testing performed by petitioner took place in petitioner's quality control laboratories in Lilly Research Laboratories. Lilly P.R. reimbursed petitioner for the cost of the quality control testing performed at its request. In addition, petitioner performed quality control tests on raw materials that it manufactured or purchased for sale to Lilly P.R.

During the years in issue, petitioner provided to Lilly P.R. and all its other subsidiaries copies of petitioner's standard procedures for the performance of quality control tests. Lilly P.R., however, developed some of its own procedures for testing raw materials. Also during the years in issue, Lilly P.R. sent copies of its assay reports on the final bulk products propoxyphene hydrochloride and propoxyphene napsylate produced by its Mayaguez facility and on certain raw materials and finished products produced by its Carolina facility to petitioner's quality assurance department in Indianapolis.

K. *Sample and Identi-dose Packaging*

During the years 1966 through 1972, under the terms of the distribution agreement, petitioner received from Lilly P.R. at no charge Darvon and Darvon-N capsules and tablets in bulk which petitioner packaged as samples. Commencing in 1973, petitioner purchased those samples at cost. During the period 1968 through 1973, petitioner purchased from Lilly P.R. at Lilly P.R.'s cost, Darvon and Darvon-N capsules and tablets in bulk which petitioner packaged in Identi-dose packages for resale to wholesalers.

VIII. *Petitioner's Marketing Operations*

A. *Introduction*

The U.S. ethical pharmaceutical industry has three characteristics that distinguish it from other industries. First, the pharmaceutical industry is research intensive. Pharmaceutical companies spend relatively greater amounts on research and development than do companies in many other industries. Second, the pharmaceutical industry is very competitive. Although petitioner has always been a leader in the pharmaceutical industry, its U.S. pharmaceutical sales accounted for only approximately 7½ percent of total pharmaceutical industry sales in the United States during the years 1971 through 1973. Third, the pharmaceutical industry is unique in that promotional efforts for ethical pharmaceutical products are directed to health care professionals such as physicians and dentists, the actual users of the products.

During the years 1971 through 1973, the primary business of petitioner's pharmaceutical division was the sale of ethical pharmaceutical products to wholesale distributors. Unlike

most companies in the pharmaceutical industry, which sell both to wholesalers and direct to certain large accounts, petitioner sold its ethical pharmaceutical products almost exclusively through a network of approximately 400 wholesalers located throughout the United States. The products sold by petitioner in 1971 through 1973 included all those manufactured by Lilly P.R. Petitioner's wholesalers generally paid petitioner's invoices within 30 days, and petitioner rarely had credit problems with its wholesalers.

During the years 1971 through 1973, petitioner's marketing efforts generally involved personal contacts by petitioner's sales representatives (called detail men) with physicians, dentists, hospitals, pharmacists, and wholesalers. In addition, petitioner's marketing operations included supportive promotional activities such as the distribution of printed literature by sales representatives, direct mail advertising, operation of exhibits at medical conventions and schools, and journal advertising.

B. *Organization*

During the years 1971 through 1973, petitioner's pharmaceutical marketing operations in the United States were organized into two functions: the "inside" function of marketing research and planning and the "outside" function of the sales force calling on health care professionals.

1. *Marketing Research and Marketing Planning*

During the years 1971, 1972, and 1973, petitioner employed approximately 160 individuals in marketing administration at its Indianapolis headquarters. Those individuals were engaged in marketing research, marketing planning, and certain staff functions for petitioner's U.S. pharmaceutical marketing operations. The function of petitioner's marketing research was to study the historical and present conditions in the U.S. pharmaceutical market and to make judgments about the future marketing activities of both petitioner and its competitors. This was done primarily by reviewing statistical data gathered by independent information services. The function of marketing planning was to develop specific strategies for the promotion of petitioner's products based upon the information produced by petitioner's marketing research. The marketing planning function also involved the preparation of printed

advertising materials to be distributed by sales representatives, by direct mail, in medical journals, and at medical conventions.

Petitioner's inside marketing function employed individuals possessing university or graduate degrees, usually in scientific areas such as pharmacy. The majority of petitioner's inside marketing personnel had experience as sales representatives.

2. *Sales Force*

Petitioner's marketing philosophy emphasized the interpersonal interaction between the sales representative and the health care professionals. Consequently, petitioner's marketing efforts were concentrated around the activities of its sales representatives. During the years 1971 through 1973, petitioner employed approximately 1,000 sales representatives throughout the United States. Those sales representatives were distributed geographically based upon petitioner's assessment of the market potential for its products in various areas of the country as well as on the distribution of the physician population within the country.

The principal function of petitioner's sales representatives was the presentation of scientific information to health care professionals about the nature and appropriate use of petitioner's pharmaceutical products. Health care professionals are a very select and well-informed group, are highly trained in their fields, and are capable of making discriminating judgments about pharmaceutical products. As a result of the scientific nature of petitioner's pharmaceutical products, and the qualifications of the audience to which petitioner's promotional efforts were directed, petitioner's sales representatives had to have scientific training. Each of petitioner's sales representatives was a college graduate, 80 percent were pharmacists, and the remainder generally had degrees in one of the life sciences. Approximately 6 percent of petitioner's sales representatives had masters degrees.

The process of calling on physicians and other health care professionals is relatively standardized in the pharmaceutical industry. The physician audience for each product is defined, and a regular schedule of periodic visits with the physicians in that audience is developed. Because physicians have a limited amount of time to meet with sales representatives of pharma-

ceutical companies, the usual visit of a sales representative with a physician occupies only 5 to 10 minutes. The frequency of such visits ranges from approximately 4 times a year to as many as 10 or 12 times a year. Due to the limited time involved in a call on a physician, the sales representative has to have a well-developed message with respect to the products he is discussing, including both the benefits of the products and their potential side effects. Generally, a sales representative visits a physician with the primary objective of discussing one particular product (called a primary detail). The sales representative also might spend a limited amount of time during the same visit on another product (called a secondary detail).

During the years in issue, petitioner's sales representatives made calls on physicians, interns, and residents in their offices or in hospitals; pharmacists in drug stores and in hospitals; the nonphysician staffs of hospitals, such as hospital administrators, nurses, and laboratory technicians; dentists; industrial clinics and nursing homes; and pharmacy, dental, medical, and nursing schools. The contacts with students in those schools were made to acquaint them with petitioner's name and products, and were informational rather than sales oriented. Petitioner's sales force was considered one of the most effective sales forces in the pharmaceutical industry in the United States.

Approximately 200 of petitioner's 1,000 sales representatives concentrated their knowledge and sales efforts in certain areas of medical specialty in order to become familiar with the special interests, problems, needs, and language of those areas of medicine. Those medical specialities included surgery, internal medicine, pediatrics, and urology. The "specialty" sales representatives were responsible for contacting physicians, residents, pharmacists, and paramedical staffs in large multidepartment hospitals, major metropolitan areas, and other places with high concentrations of specialized medical practices.

During 1972, petitioner formed a second sales force in addition to its 1,000 man regular sales force. The new sales force, called Dista, consisted of approximately 150 sales representatives and was formed to market products directed to primary care physicians, that is, general practitioners, family

practitioners, and other physicians working in office-based, non-hospital environments. The management personnel for the Dista sales force came from petitioner's existing sales force. The Dista sales representatives primarily were new employees hired by petitioner, although some Dista sales positions were filled by existing sales representatives of petitioner. The educational background of the Dista sales force was similar to the educational background of petitioner's regular sales force.

C. *Regulation of Promotional Claims*

During the years in issue, the FDA placed specific constraints on the content of promotional claims for ethical pharmaceutical products. When an NDA was approved by the FDA, the FDA and the manufacturer agreed on the content of a document called a "package insert," which accompanied each package of the product sold by the manufacturer. The package insert was a very comprehensive document that described, in scientific terms, the chemical composition of the drug, its medical actions, its indications (i.e., the medical conditions for which it was to be used), and its contraindications (i.e., the medical conditions for which the drug should not be used). The insert also provided information with respect to administration and dosage, the dangers of using the drug, precautions that should be taken by the physician, adverse reactions, interactions with other drugs, and the treatment of overdose situations. The claims for the drug as set forth in the package insert had to be demonstrated to the satisfaction of the FDA on the basis of clinical studies performed with the drug. Federal law prohibited the promotion of a drug for uses other than those included in the package insert.

In addition, pharmaceutical manufacturers submitted to the FDA copies of all promotional materials for clearance prior to use. After the drug was on the market, the FDA periodically reviewed all promotional materials. Package inserts could be amended from time to time to add new uses for the drug established by clinical studies or to add additional warnings and information with respect to adverse reactions. The package inserts used by petitioner were developed by the medical and scientific personnel of petitioner's Lilly Research Laboratories.

D. *Marketing of Darvon and Darvon-N Products*

By 1971, Darvon products had been sold for 13 years and were well established in the market place as leading analgesic drugs. During the years 1971 through 1973, petitioner introduced Darvon-N products. Darvon and Darvon-N products together were the most frequently prescribed ethical pharmaceutical products in the United States during the years 1960 through 1973.

During the years 1971 through 1973, Darvon and Darvon-N products were petitioner's largest selling product line and as such received a major share of petitioner's marketing attention and efforts. Physicians at that time knew what Darvon products were and how they fit into their practices of medicine. Consequently, petitioner's marketing efforts for Darvon products during those years were in the nature of advising physicians of new developments concerning Darvon products and attempting to expand their uses of those products. As Darvon-N products had been introduced only recently, petitioner concentrated its marketing efforts for propoxyphene products during the years 1971 through 1973 upon Darvon-N in order to inform physicians and other health care professionals of that new product line.

Petitioner's marketing efforts for Darvon and Darvon-N products were directed principally to primary care physicians, that is, physicians who treat patients initially as opposed to specialists to whom patients are referred. However, almost all physicians were candidates for the promotion of analgesic drugs because of the broad incidence of pain resulting from many types of illnesses and injuries. Consequently, petitioner's target audience for Darvon and Darvon-N products was very broad. Petitioner promoted Darvon and Darvon-N products primarily through its regular sales representatives rather than through its specialty sales representatives or Dista sales force.

E. *Pricing of Darvon and Darvon-N Products*

Petitioner's prices to wholesalers for its pharmaceutical products were determined primarily by petitioner's assessments of what the marketplace was willing to pay for those products. Although the profitability of a product was a factor

in pricing decisions, the prices of petitioner's products were not directly related to its costs of producing those products.

Health care professionals generally categorize drugs as either relatively expensive or relatively inexpensive. The price of a drug can be a material concern to the health care professional when choosing among relatively expensive drugs; price, however, is usually not a material concern to the health care professional when choosing among relatively inexpensive drugs. Oral analgesics, and particularly propoxyphene products, were viewed by health care professionals as being relatively inexpensive drugs. During the years in issue, the average prescription price (i.e., the price paid by the patient at the drug store) for a bottle of 30 Darvon capsules was approximately $4. Thus, Darvon products cost the patient approximately 13 cents per capsule or about 50 cents per day (the recommended dose of Darvon products was four capsules per day).

The reason why health care professionals are not concerned when choosing among relatively inexpensive drugs such as Darvon products is that the differences in the wholesale prices for the drugs are not fully reflected in their retail prices. Pharmacists in drug stores rarely determine their prices for less expensive drugs based on a markup over cost, but rather charge a dispensing fee of approximately $2 for each prescription. For example, if a prescription for a Darvon products costs the patient $4 in the drug store, the pharmacist's ingredient cost would be approximately $2 (the $4 price less the $2 dispensing fee). Therefore, if the pharmacist's ingredient cost was produced by 50 percent to $1, the pharmacist's price to the patient would be reduced only 25 percent from $4 to $3.

Although petitioner anticipated that competitors would enter the market with generic propoxyphene products after the propoxyphene patent expired in 1972, petitioner did not decrease its prices for Darvon products. Petitioner expected that its competitors would price such generic products at levels lower than petitioner's prices but no less than half of petitioner's prices. If the price of a generic propoxyphene product was half that of the Darvon product, the difference in the prescription price to the patient, using the figures in our example, would be approximately $1 for a prescription of 30 capsules or only about 3 cents a capsule. Petitioner believed that, given

the small difference in the prescription price to the patient, physicians would continue to prescribe the Darvon product, a known product which they had used over several years, rather than a new generic product.

F. *Significance of Marketing Intangibles*

For many years, petitioner has enjoyed a favorable reputation in the marketplace as a result of bringing to the market a succession of therapeutically successful products. Petitioner also has developed over the years a marketing organization that is highly skilled in the promotion of pharmaceutical products. The fact that petitioner marketed several successful pharmaceutical products and enjoyed a good reputation made it easier for petitioner's sales representatives to obtain access to health care professionals in order to discuss petitioner's other products.

Although petitioner's reputation gave it access to health care professionals, such access was no assurance that a new product marketed by petitioner would be successful. Health care professionals, as stated earlier, are a sophisticated and discriminating audience, and they will not automatically accept any new product marketed by petitioner. Petitioner, in fact, marketed several products during the 1960's and 1970's that were unsuccessful despite the fact that those products were heavily promoted by petitioner's sales force under petitioner's well-known and respected name.

It often takes several years to determine whether a new drug will prove to be successful in the marketplace. In petitioner's experience, health care professionals ordinarily will try a new drug only if it promises to perform more satisfactorily than the drugs already available and used by them. If a health care professional tries the drug and finds that it works satisfactorily, he then gradually may broaden his use of the drug in his practice. In addition, although new drugs undergo extensive clinical testing before marketing, it is not uncommon to discover new information about the drug, such as adverse reactions, after it has been on the market and in general use. Furthermore, as the marketing of a new drug is usually more expensive in the early years due to the marketing effort required to inform health care professionals about

the new drug, a new drug may not produce substantial economic returns to the manufacturer for many years.

It was clear by 1966 that the Darvon product line was an extraordinarily successful product line. It then had an 8-year demonstrated history of substantial sales, establishing its position as a leader in the prescription oral analgesic market. The Darvon product line was well known among health care professionals and others. It was also extremely profitable. For those reasons, the Darvon product line had a substantial intangible value in 1966.

If petitioner had lost the right to use the Darvon trademark at some point during the period 1966 through 1971, the sales and profit performance of petitioner's propoxyphene hydrochloride products would not have been materially affected, provided petitioner had the exclusive right to market those propoxyphene hydrochloride products. Because propoxyphene hydrochloride products had been on the market since 1957, those products were well known in the medical community. Health care professionals were aware that the generic name for the active ingredient in Darvon products was propoxyphene hydrochloride because labels, product information, and other literature regarding Darvon products all prominently displayed that fact.

The loss of the trademark would have caused petitioner to incur only a minor amount of additional marketing costs for a short period of time. Petitioner would have had to inform health care professionals that the propoxyphene hydrochloride products previously marketed by it under the trademark Darvon were no longer available under that trademark but only under a new trademark. More importantly, petitioner would have had to advise retail pharmacists of the trademark change. Pharmacists were legally prohibited during those years from substituting, without the consent of the prescribing physician, a generic drug for the drug prescribed by the physician. If a pharmacist had received a prescription for a Darvon product, he probably would have called the prescribing physician, advised him that propoxyphene hydrochloride products were no longer sold under that trademark but under a new one, and requested permission from the physician to fill the prescription with the new trademarked product. Such a procedure was generally standard among pharmacists. The

physician in most instances would have granted the permission requested because he was interested in prescribing for his patient the therapeutic agent, propoxyphene hydrochloride, and the Darvon trademark as such was of little importance to him.

IX. *Petitioner's Research and Development Activities*

A. *Introduction*

During the years 1971, 1972, and 1973, petitioner's Lilly Research Laboratories conducted research and development in the life sciences with the objectives of inventing, developing, and improving pharmaceutical, agricultural, and cosmetic products. All the products manufactured by Lilly P.R. during those years, as well as most of the ethical pharmaceutical products of petitioner, were developed by Lilly Research Laboratories, a division of petitioner, solely or in conjunction with research facilities of petitioner's subsidiaries.

During the years 1971 through 1973, the research and development facilities of Lilly Research Laboratories were located at McCarty Street in Indianapolis, at the Wishard Memorial Hospital in Indianapolis, and at Greenfield, Indiana.

Petitioner's research and development facilities at McCarty Street in Indianapolis occupied approximately 775,000 square feet of space and had a book value of approximately $23.3 million at the end of 1973. In 1972, petitioner completed and occupied a new building at McCarty Street (called Building 88) that approximately doubled petitioner's research facilities. The pharmaceutical pilot plant on Kentucky Avenue in Indianapolis also was considered part of the McCarty Street research facilities.

The Lilly Laboratory for Clinical Research (often called the Lilly Clinic) was located on the seventh floor and half of the sixth floor of the Wishard Memorial Hospital in Indianapolis and occupied approximately 67,000 square feet of space. Petitioner's assets at that location had a book value of approximately $698,000 at the end of 1973. Wishard Memorial Hospital was a government-owned institution staffed by the University of Indiana Medical School. The Lilly Clinic was a 40-bed facility responsible for initial tests of new pharmaceutical compounds in human volunteers. Approximately 125

employees of Lilly Research Laboratories worked at the Lilly Clinic.

Petitioner's Greenfield Laboratories were located on a 750-acre site near Greenfield, Indiana. The facility occupied approximately 420,000 square feet of space, and had assets with a book value of approximately $11.6 million at the end of 1973.

During the years 1971 through 1973, Lilly Research Laboratories employed approximately 2,000 persons. Approximately 8 percent of those employees were research executives, 13 percent were senior scientists who held Ph.D. degrees, 35 percent were scientists not holding Ph.D. degrees, and the remaining 44 percent were technicians, secretaries, animal caretakers, and other support personnel. The executives and scientists at Lilly Research Laboratories included physicians, chemists, biologists, microbiologists, physiologists, and pharmacologists.

The activities of Lilly Research Laboratories were directed by four general committees during the years 1971 through 1973. Those committees were: (1) The research projects committee; (2) the product development committee; (3) the product introduction committee; and (4) the product addition committee. The objective of those committees was to create new compounds that could be recommended for clinical or field trial testing. The recommendation of those committees was forwarded with accumulated data relative to the compound involved to a research management group. If the research management group agreed with the recommendation of the committees and the evaluations of the chemical work done with respect to the recommendation, the compound was forwarded for development.

The research and development work on each compound was done by designated teams drawn from the four divisions of Lilly Research Laboratories. The divisions were organized into two major categories. The first category contained the research, development, and control divisions. The second category consisted of the medical research division.

The research division of Lilly Research Laboratories was responsible for creating new compounds, screening compounds for potential product development, and studying the initial toxicological effects of those compounds. That division per-

formed the general or basic research function of Lilly Research Laboratories. A research team was established to search for new compounds in each general area of interest to petitioner, such as cardiovascular drugs, anti-cancer drugs, or analgesic drugs. A research project number was established to cover the work of each of those research teams. The research division synthesized thousands of new chemical compounds every year. In the pharmaceutical industry, approximately 8,000 new compounds are synthesized for each compound that finally is marketed as a new drug.

The development division of Lilly Research Laboratories was responsible for developing compounds that had been screened by the research division and that appeared to have marketing potential. Such development activities included performance of short- and long-term toxicology studies, development of a manufacturing process, production of clinical trial materials, and performance of clinical studies. When a new compound identified by the research division was forwarded by the research committees for development, a product development team was established for that compound and a product development number was established to cover the work of that team.

The control division of Lilly Research Laboratories was responsible for the performance of analytical assays on research materials, purchased materials, and manufactured items. That division was basically a service operation providing analytical testing for the research, development, and medical research divisions of Lilly Research Laboratories. The primary function of the control division was to perform the required quality control tests on each lot of each product manufactured by petitioner in the United States.

The medical research division of Lilly Research Laboratories was responsible for conducting, coordinating, and evaluating human clinical tests to establish the safety and efficacy of new pharmaceutical compounds. Its activities also included the preparation and submission of NDAs.

During the years 1971, 1972, and 1973, the research and development expenses of Lilly Research Laboratories were $53,513,000, $59,502,000, and $65,551,000, respectively. Those amounts represented all of petitioner's research and development expenditures with the exception of certain development

expenditures for petitioner's antibiotic development division that were not incurred by Lilly Research Laboratories. The expenses of the control division of Lilly Research Laboratories were included in the above amounts only to the extent that assays were performed by the control division on materials used or produced by the research, development, or medical research divisions. The remaining expenses of the control division were transferred to petitioner's production departments and were included in petitioner's cost of products sold.

Petitioner generally performed three types of research. One was fundamental research, which included the basic research necessary to synthesize and screen new chemical compounds. The fundamental research laid the groundwork for the second type of research, product-oriented, or defined, research. That research included activities related to the development of pharmaceutical compounds and the preparation of NDAs. Defined research covered the time period from the establishment of a product development team for a promising compound to the approval of an NDA for that compound. The third type of research, support research, involved activities performed after the compound had been marketed. During the years 1971 through 1973, the fundamental research category accounted for approximately 60 percent of the total research and development expenditures of Lilly Research Laboratories. Defined research accounted for approximately 20 percent of those expenditures, and support research accounted for approximately 20 percent.

The research and development expenses of Lilly Research Laboratories for pharmaceutical, agricultural, and cosmetic research and development projects for the years 1971, 1972, and 1973 were as follows (000's omitted):

Area of research	*1971*	*1972*	*1973*[10]
Pharmaceutical	$40,393	$45,397	$49,632
Agricultural	12,830	13,979	15,765
Cosmetic	290	126	153
Total	53,513	59,502	65,551

[10]The parties have stipulated the amounts of the expenses. We accept them as fact although the amounts do not total $65,551,000, as shown.

B. *Food and Drug Administration Requirements*

The Federal Food, Drug, and Cosmetic Act (21 U.S.C. secs. 301–392) requires the submission and FDA approval of an NDA[21] prior to the introduction into interstate commerce of any new drug, including patented drugs. Subsequent to 1962 and throughout the years 1971 through 1973, the process for obtaining an NDA involved as a prior step the filing of a document known as an Investigatory New Drug Application (hereinafter IND).

An IND contained the background of the new drug at the point in time at which it was filed. It described the method and chemistry of synthesizing the new drug; the procedures and tests for controlling the quality of the drug; summaries of animal pharmacology tests performed to assess the drug's therapeutic potential; results of animal toxicology studies performed to assess the safety of the drug; the labeling the developer intended to use to ship the drug in interstate commerce; the names of the investigators who would be conducting the clinical studies in humans; and the plans or protocols to be used in those studies.

Petitioner's INDs were prepared by the regulatory affairs department of Lilly Research Laboratories' medical research division. During the years in issue, the regulatory affairs department had approximately 60 employees. The preparation of an IND was largely a process of collating finished packages of materials received from other areas of Lilly Research Laboratories. It took two or three of the clerical personnel in that department approximately 2 to 3 days to collate and duplicate an IND.

Assuming that the FDA did not have serious objections with respect to the IND, the pharmaceutical company was free to begin clinical studies in humans after a 30-day waiting period. The clinical studies for a new drug generally were divided into three phases referred to as phase I, phase II, and phase III. Although there were qualitative distinctions in the nature of the clinical studies performed in each phase, the three phases were not performed in strict chronological order and often overlapped in time.

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[21] The required application for new drugs other than antibiotics is called an NDA. The required application for an antibiotic drug is FDA Form 5 and contains essentially the same information as an NDA. For convenience, both NDAs and Forms 5 are referred to herein as NDAs.

Phase I clinical studies consisted largely of dose ranging studies in normal human subjects. During the years in issue, phase I clinical studies usually involved 20 to 50 subjects and took from 3 to 6 months to complete, depending upon the new drug being tested. Petitioner's phase I studies ordinarily were performed in the Lilly Clinic.

Phase II clinical studies were the initial efficacy studies for the new drug. The purpose of those studies was to demonstrate that the drug had some valuable, therapeutic activity. In those studies, the new drug was given to a small number of patients who had the disease or medical condition that the new drug was intended to treat.

At some point during phase II, sufficient information with respect to the efficacy and toxicity of the new drug was accumulated to permit a decision as to whether the new drug would be able to complete successfully the FDA approval process or whether the testing of the new drug should be abandoned. That point in a new drug's development was referred to as the NDA decision point. The NDA decision point was important because it was at that time that it was decided whether to commit the considerable resources necessary to complete the phase II and phase III clinical studies for the new drug. The amount of time between the end of phase I and the NDA decision point varied greatly depending upon the new drug being tested, but generally ranged between 1 and 2 years.

Phase III studies were similar to and essentially a continuation of phase II studies. Phase III studies, however, were more extensive. They involved more patients than were involved in phase II studies, and more attributes of a new drug were assessed. The drug was tested under various dosage schedules and in conjunction with other drugs. A major objective of phase III studies was to expose large numbers of patients to the new drug to collect information with respect to potential side effects or abnormalities in the patients and for the large body of safety data necessary to support an NDA.

Petitioner generally attempted to have its new drugs investigated by well-known clinical investigators, outside physicians who were paid by petitioner to study the new drugs. The testing usually was done at large teaching hospitals in various locations around the country to provide test data under various conditions. Petitioner contracted with those clinical

investigators and provided them with case report forms on which to report the data produced by the clinical studies. The case report forms completed by the clinical investigators were forwarded to petitioner's regulatory affairs department where they were entered into a computer. The regulatory affairs department worked with petitioner's computer analysts and statisticians to devise computer-generated tables summarizing the clinical data, which tables eventually became part of the applicable NDAs. The time from the NDA decision point to the completion of phase III clinical studies varied greatly depending on the drug being tested but generally ranged between 2 and 3 years.

The NDA was in large part a duplication and elaboration of the material included in an IND. The NDA included the information originally submitted in the IND and all additional information the applicant had collected relative to the new drug, including but not limited to: (1) Detailed descriptions of the manufacturing and quality control procedures; (2) any animal pharmacology studies done subsequent to the filing of the IND; (3) any animal toxicology studies done subsequent to the filing of the IND; (4) all information relative to phases I, II, and III clinical studies on humans during the IND process, including the names of the investigators and the results of their research; (5) the labels and labeling information; and (6) the package insert for the new drug. The NDA material submitted to the FDA generally was voluminous.

By regulation, the FDA had 180 days from the filing of an NDA within which to respond. The FDA could and often did ask questions with regard to the clinical, toxicology, and pharmacology studies reported in the NDA. When such questions were raised with respect to NDAs filed by petitioner, personnel of petitioner's regulatory affairs department or the individuals in Lilly Research Laboratories who prepared the data submitted with the NDA discussed those questions with the FDA. If necessary, petitioner supplied additional information to the FDA. During that interaction period, a regional office of the FDA conducted an inspection of the manufacturing facilities to be used to produce the new drug. Inspections of Lilly P.R.'s manufacturing facilities were conducted by the local Puerto Rican office of the FDA.

When the FDA completed its review of the NDA, and if the FDA was satisfied, it issued a letter stating that the new drug was approvable contingent upon a review of final printed labeling and package inserts. When petitioner received an approvable letter from the FDA, it printed final labeling and package inserts for the new drug and submitted those materials to the FDA. At that point, petitioner also submitted to the FDA the promotional materials it planned to use to market the drug. If the FDA found those materials satisfactory, it issued a letter to petitioner approving the NDA and giving petitioner the right to market the new drug.

During the years 1971 through 1973, the average period from the filing of an NDA to its final approval by the FDA was approximately 2 years. Only 1 in every 10 new drugs for which an IND was filed, successfully completed the process and received FDA approval. While the time frame leading to an NDA varied extensively, the entire procedure from the initial chemical synthesis and identification of a new drug to the approval of an NDA for the new drug ranged from approximately 7 years to 13 years.

The approval letters issued by the FDA contained specific provisions and conditions relative to the maintenance of that approval. The pharmaceutical companies were required to maintain certain records and to make certain periodic reports to the FDA. The companies were required to report every 3 months for the first year, every 6 months the second year, and annually thereafter. In addition, the pharmaceutical companies were required to submit to the FDA any information concerning accidents or certain complaints relative to a drug on a priority basis. Immediate notification was required of labeling mix-ups, bacteriological contamination, or chemical degradation; notification was required within 15 days of receiving complaints or learning of serious, unexpected side effects of a drug.

If a pharmaceutical company desired to make any major change in the manufacturing or marketing of a drug, such as the addition of a new indication for the drug or a change in its dosage schedule, additional materials were submitted to the FDA in the form of a supplemental NDA. The supplemental NDA described the desired change and included data supporting that change.

FDA approved NDAs cannot be assigned or transferred by pharmaceutical companies. The approved NDA is peculiar to the pharmaceutical company that obtained it because it contains information specific to that company. A second pharmaceutical company desiring to market the same drug would be required to file and obtain approval of its own NDA for the drug. If the pharmaceutical company that originally obtained FDA approval to market the drug granted the second pharmaceutical company the right to refer to the information in the first company's NDA file, the second company could obtain FDA approval of an NDA simply by submitting to the FDA the appropriate labeling, manufacturing, and quality control information. The first company's NDA file in that situation is referred to as a "master file." During the years 1971 through 1973, a master file could be referred to only with the permission of its sponsor. A "sponsor," in the FDA context, is the company that submitted the IND and NDA, and is the party responsible for maintaining records and submitting the periodic reports to the FDA.

C. *Research and Development of Propoxyphene Products 1967–73*

1. *General*

During the years 1967 through 1973, Lilly Research Laboratories conducted research and development activities with respect to propoxyphene products for the benefit of Lilly P.R. The expenses of those activities, as determined using Lilly Research Laboratories' accounting system, were billed to and paid by Lilly P.R. pursuant to the joint research agreement.

Because propoxyphene products had been on the market since 1957, the propoxyphene research and development activities of Lilly Research Laboratories generally were categorized by petitioner as support research. The support research primarily consisted of the development of new formulations of propoxyphene products. Lilly P.R. participated by producing some materials for testing by Lilly Research Laboratories, and by working with Lilly Research Laboratories to develop manufacturing processes and manufacturing tickets for the new product formulations.

2. *Research Projects*

During the years 1967 through 1973, the research and

development activities of Lilly Research Laboratories with respect to propoxyphene products primarily were conducted under nine research and product development projects established by Lilly Research Laboratories.[22] Four of the product development projects (PD 1464, PD 1627, PD 2204, and PD 2308) were established by Lilly Research Laboratories prior to 1967. Research and development activities on those projects during the years 1967 through 1973 primarily consisted of formula revisions to improve product stability and the attempted development of a sustained release drug delivery system. Lilly Research Laboratories focused on the use of propoxyphene products in sustained release form from 1971 through 1973, when it terminated all work on sustained release formulations. Petitioner never marketed a propoxyphene product in sustained release form.

The remaining five research and product development projects (PD 3012, PD 3016, RP 1638, 0805, and 0694) were established by Lilly Research Laboratories during the years 1967 through 1973. PD 3012 (Darvon-N and combination products) was established to cover the development of formulations and manufacturing processes for Darvon-N products. Approximately one-half of the research and development expenses of Lilly Research Laboratories incurred with respect to propoxyphene products during the years 1967 through 1973 were incurred under that project number.

PD 3016 (Sphercotes Darvon) was a product development project established after 1966 for the purpose of developing new formulations of Darvon products containing aspirin. Prior to 1970, the interaction of propoxyphene hydrochloride and aspirin in Darvon products was prevented by forming the propoxyphene hydrochloride into a coated tablet, called a sphercote. During the 1960's, it was discovered that that formulation was subject to misuse because the sphercote of propoxyphene hydrochloride could be extracted from the Darvon capsule. The objective of PD 3016 was to eliminate the use of the sphercote by developing new all-powder formulations of Darvon products containing aspirin. In 1970, Dr.

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[22] Lilly Research Laboratories also utilized a research project number (RP 1195) for studies of analgesics in general. Some information obtained from studies under RP 1195 was submitted as support for Darvon-N related NDAs during the years 1971 through 1973; however, the studies were not specifically related to propoxyphene products.

Walter D. Walkling, a research chemist at Lilly Research Laboratories, discovered a method of stablizing aspirin in the presence of propoxyphene hydrochloride by incorporating glutamic acid hydrochloride in pharmaceutical compositions of aspirin and propoxyphene hydrochloride. The addition of glutamic acid hydrochloride to those formulations had a stablizing effect on the formulation and prevented the decomposition of the aspirin. A U.S. patent (4,044,125) covering that formulation was issued to petitioner as assignee of Dr. Walkling on August 23, 1977. The glutamic acid hydrochloride formulation was used by Lilly P.R. in the manufacture of Darvon with A.S.A. (PU 366), Darvon Compound (PU 368), and Darvon Compound-65 (PU 369) during the years 1971 through 1973.

RP 1638 was a research project established for the purpose of developing a formulation and manufacturing process for Darvocet®, a product that petitioner ultimately never manufactured or marketed. Project numbers 0805 and 0694 were short-term projects for the revision of the formulas for Darvon products.

3. *NDAs*

Petitioner filed with the FDA the following NDAs covering its Darvon and Darvon-N products:

Product	*NDA number*	*Date filed*	*Date approved*
Darvon 32 mg. (PU 364)	10-977	Mar. 25, 1957	Sept. 9, 1957
Darvon 65 mg. (PU 365)	10-977	Mar. 25, 1957	Sept. 9, 1957
Darvon with A.S.A. (PU 366)	10-996	Jan. 24, 1964	Sept. 24, 1964
Darvon Compound (PU 368)	10-996	Mar. 25, 1957	Sept. 23, 1957
Darvon Compound-65 (PU 369)	10-996	July 5, 1960	Sept. 22, 1960
Darvo-Tran (PU 377)	12-032	June 26, 1959	Sept. 4, 1959
Stero-Darvon (TA 1855)	14-768	June 17, 1963	May 3, 1967
Darvon-N (PU 391 and PU 392)	16-827	Nov. 13, 1968	Sept. 9, 1971[23]
Darvon-N (TA 1883)	16-863	May 19, 1969	Sept. 9, 1971
Darvon-N with A.S.A. (TA 1884)	16-863	May 19, 1969	Sept. 9, 1971
Darvon-N Suspension (MS 135)	16-861	May 19, 1969	Sept. 9, 1971
Darvocet-N 50 (TA 1890)[24]	17-122	Dec. 17, 1971	Dec. 19, 1972

[23]NDA No. 16-827 covered Darvon-N capsules. Petitioner, however, decided not to market Darvon-N in capsule form.

[24]On Mar. 12, 1973, petitioner filed an NDA (No. 17-122) with the FDA covering Darvocet-N 100 (TA 1893). Darvocet-N 100 is the same product as Darvocet-N 50, except that it contains twice the amounts of propoxyphene napsylate and acetaminophen contained in Darvocet-N 50. The NDA was approved on Nov. 12, 1973, but petitioner did not market Darvocet-N 100 until 1974.

Petitioner was the sponsor for all the NDAs for Darvon and Darvon-N products.[25] Petitioner informed the FDA in those NDAs or in supplemental NDAs that the products covered by those NDAs would be manufactured in Puerto Rico by Lilly P.R. However, as sponsor, petitioner was still the entity responsible for maintaining records and reports and the entity accountable for problems with Darvon and Darvon-N products.

The NDAs for all Darvon and Darvon-N products approved by the FDA during the years 1965 through 1973 referred, directly of indirectly, to the basic Darvon NDA master file NDA NO. 10-977). Petitioner did not permit a third party seeking to market a new pharmaceutical product to refer to any of its master file NDAs during the years 1971 through 1973.

If Lilly P.R. had had to compile and submit its own NDAs for Darvon and Darvon-N products, the time and expense necessary would have been substantial. The typical NDA submission for a new drug was sizable due to the large number of clinical studies necessary to show its safety and efficacy. For example, petitioner's NDA NO. 16-827 consisted of 23 volumes containing a number of pharmacology, toxicology, and pain studies. Those studies were performed prior to the filing of NDA NO. 16-827 on November 15, 1968.

Although NDA NO. 16-827 was a large submission, it was not as extensive as an NDA for an entirely new drug. NDA NO. 16-827 would have been required to contain substantially more clinical studies if it had been the first NDA for a propoxyphene product. In 1969, petitioner filed an NDA for an oral cephalosporin antibiotic sold under the trademark Keflex®. The Keflex NDA contained 88 volumes. NDAs for antibiotics ordinarily are less extensive than NDAs for analgesic drugs. There are objective measurements of effectiveness of an antibiotic drug, and as a result it is easier to develop evidence of efficacy. In contrast, the effects of an analgesic drug are more subjective and, therefore, more difficult to measure. If NDA NO. 16-827 had been the first NDA for a propoxyphene product, it probably would have been larger than, and perhaps twice as large as, petitioner's NDA for Keflex.

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[25] All animal and human testing, as well as the preparation of all correspondence, associated with obtaining FDA approval of NDAs for Darvon and Darvon-N products was performed or contracted by Lilly Research Laboratories.

X. *Litigation Related to Propoxyphene Products*

During the years 1966 through 1973, petitioner or Lilly P.R. brought three patent infringement actions to defend the propoxyphene patent. Those actions were *Eli Lilly & Co. v. Generic Formulas, Inc.*, 66 Civil Action File 576 (E.D.N.Y. Sept. 30, 1966); *Eli Lilly & Co. v. Milan Pharmaceutical, Inc.*, No. C-68 13F, 169 U.S.P.Q. 32 (N.D.W.Va. 1968); and *Eli Lilly & Co. v. Generix Drug Sales, Inc.*, No. 69-1241-Civ., 324 F. Supp. 715 (S.D. Fla. 1971), affd. in part and vacated and remanded in part 460 F.2d 1096 (5th Cir. 1972). The validity of the propoxyphene patent was upheld in each of those actions, and injunctions were issued prohibiting further infringement of the patent by each defendant. The legal fees for the Generic Formulas, Inc., action, which was concluded prior to the execution of the Assignment of Patents and Related Technical Data on December 5, 1966, were paid by petitioner. Lilly P.R. bore the legal fees incurred in connection with the Milan Pharmaceutical, Inc., and Generix Drug Sales, Inc., actions. The legal fees and related costs billed to Lilly P.R. by petitioner with respect to the Milan and Generix actions during the years 1968 through 1973 were as follows:

Action	*Year*	*Amount*
Milan	1968	$42,322
	1969	35,984
	Total	78,806
Generix	1970	276,149
	1971	473,625
	1972	120,547
	1973	25,744
	Total	**896,065
Total for both Milan and Generix actions		974,871

During the period from 1957 through 1973, a total of six lawsuits were filed against petitioner or Lilly P.R. for damages allegedly resulting from the use of Darvon or Darvon-N products. Petitioner settled the first suit by paying the plaintiff $1,000. The remaining five lawsuits were dismissed and no damages were paid to the plaintiffs by petitioner or

**The parties incorrectly stipulated this number as $897,065. We have found what we consider to be the correct total.

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Lilly P.R. Petitioner's legal fees paid in defense of all six lawsuits aggregated approximately $51,000. Those legal fees were not reimbursed by Lilly P.R. but were included in petitioner's general and administrative expenses.

XI. *Intercompany Pricing of Darvon and Darvon-N Products*

A. *General*

During the years 1971 through 1973, petitioner purchased its complete line of Darvon and Darvon-N products from Lilly P.R. Listed below are the Darvon and Darvon-N products purchased by petitioner for resale to customers in the United States during those years:

Identification code	*Description*	*Packaging size(s)*[27]
PU 364	Darvon 32 mg.	100,500
PU 365	Darvon 65 mg.	100,500, 25/30, 20/50
PU 366	Darvon with A.S.A.	100,500
PU 368	Darvon Compound	100,500
PU 369	Darvon Compound-65	100,500, 25/30, 20/50
PU 377	Darvo-Tran	100,500
TA 1855	Stero-Darvon	50
TA 1883	Darvon-N	100,500, 25/30, 20/50
TA 1884	Darvon-N with A.S.A.	100,500, 25/30, 20/50
TA 1890	Darvocet-N 50	100,500, 20/50
MS 135	Darvon-N Suspension	Pint, ID 10cc

Petitioner also received finished Darvon and Darvon-N capsules and tablets in bulk packages from Lilly P.R. for use as samples or to be packaged in unit-dose packaging. Petitioner's unit-dose packagings were (a) an ID 100 Identi-dose package consisting of 100 strips of 10 individually labeled blisters, each containing 1 capsule or tablet, and (b) a DS 1000 package containing 10 dispenser rolls, each consisting of 100 capsules in individual unit-dose packages. The unit-dose packaging was performed or contracted in the United States by petitioner and was not performed by Lilly P.R. at any time prior to 1974.

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[27] The 50-, 100-, and 500-package sizes refer to bottles of 50, 100, and 500 capsules or tablets, respectively. The 25/30-package size was a package containing 25 packages of 30 capsules or tablets. The 20/50-package size was a package containing 20 packages of 50 capsules or tablets. The ID 10cc-package size for Darvon-N Suspension was an Identi-dose package of 100 individually labeled bottles each containing one dose.

Petitioner's cost of Identi-dose packaging was included in its cost of sales of Darvon and Darvon-N products.

During the years 1965 through 1973, all pharmaceutical products sold by petitioner in the United States were listed in petitioner's published price lists. The prices in petitioner's price lists were its suggested prices to retail pharmacies and were referred to as "net trade prices." During that period, drug wholesalers of petitioner's products received a standard discount of 17 percent from petitioner's net trade prices. Petitioner's prices to drug wholesalers were referred to as "net wholesale prices."

Petitioner's net trade prices and net wholesale prices for the Darvon and Darvon-N products manufactured and sold by Lilly P.R. during the years 1966 through 1973 were as follows:

Identification code	*Package size*	*Description*	*Net trade price*	*Net wholesale price*
PU 364	100	Darvon 32 mg.	$3.72	$3.10
PU 364	500	Darvon 32 mg.	17.67	14.72
PU 365	100	Darvon 65 mg.	7.02	5.85
PU 365	500	Darvon 65 mg.	33.35	27.79
PU 365	25/30	Darvon 65 mg.	52.53	43.77
PU 365	20/50	Darvon 65 mg.	68.80	57.33
PU 366	100	Darvon with A.S.A.	7.11	5.92
PU 366	500	Darvon with A.S.A.	33.77	28.14
PU 368	100	Darvon Compound	4.02	3.35
PU 368	500	Darvon Compound	19.10	15.92
PU 369	100	Darvon Compound-65	7.32	6.10
PU 369	500	Darvon Compound-65	34.77	28.97
PU 369	25/30	Darvon Compound-65	54.66	45.55
PU 369	[1]20/50	Darvon Compound-65	71.60	59.67
PU 377	100	Darvo-Tran	5.40	4.50
PU 377	500	Darvo-Tran	25.65	21.37
TA 1855	50	Stero-Darvon	3.62	3.02
TA 1883	100	Darvon-N	7.02	5.85
TA 1883	500	Darvon-N	33.35	27.79
TA 1883	25/30	Darvon-N	52.53	43.77
TA 1883	20/50	Darvon-N	68.80	57.33
TA 1884	100	Darvon-N with A.S.A.	7.11	5.92
TA 1884	500	Darvon-N with A.S.A.	33.77	28.14
TA 1884	25/30	Darvon-N with A.S.A.	53.16	44.30
TA 1884	20/50	Darvon-N with A.S.A.	69.60	58.00
TA 1890	100	Darvocet-N 50	4.10	3.42
TA 1890	500	Darvocet-N 50	19.48	16.23

Identification code	*Package size*	*Description*	*Net trade price*	*Net wholesale price*
TA 1890	20/50	Darvocet-N 50	$41.00	$34.17
MS 135	Pint	Darvon-N Suspension	4.79	3.99
MS 135	ID 10cc	Darvon-N Suspension	21.98	18.32

[1]We have corrected the parties' erroneous stipulation of this package size as 20/30.

During the years 1966 through 1973, Lilly P.R. sold Darvon products to petitioner at the following discounts from petitioner's net wholesale prices:

Year	*Discount* [28]
1966	35%
1967	40
1968	40
1969	45
1970	45
1971	[1]40
1972	[1]46
1973	[1]58

[1]These discounts also applied to Darvon-N products sold by Lilly P.R. to petitioner.

Pursuant to the distribution agreement between Lilly P.R. and petitioner, Lilly P.R. granted petitioner "chargebacks," or rebates, for export and U.S. Government sales of Darvon and Darvon-N products by petitioner. During the years 1971 through 1973, the chargebacks were equal to 20 percent of petitioner's net wholesale price for the volume of material sold in export and to the Government.[29] During the years 1971 through 1973, petitioner's export and Government sales of Darvon and Darvon-N products were 3 to 4 percent of its total sales of those products.

During the years 1966 through 1972, the distribution agreements between petitioner and Lilly P.R. provided that Lilly P.R. would provide free samples of Darvon and Darvon-N products to petitioner. In practice, that was accomplished by Lilly P.R. granting chargebacks to petitioner for Darvon and

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[28]The parties have stipulated these figures as being the discounts in effect during the years stated. We note, however, that the stipulated discounts often were in effect for only part of the respective years. For example, the discount for 1971 was 45 percent as of Jan. 1, 1971. That discount was reduced to 40 percent for Darvon products in March 1971, and for Darvon-N products in August 1971.

[29]During January and February 1971, the chargeback percentage was 15 percent.

Darvon-N products used as samples by petitioner. For samples packaged by petitioner from bulk capsules or tablets purchased from Lilly P.R., the chargeback was equal to the price petitioner paid Lilly P.R. for the bulk capsules or tablets, plus petitioner's costs of packaging the bulk capsules and tablets in sample packages. For trade packages (such as bottles of 100 capsules or tablets) used as samples, the chargeback was equal to the price petitioner paid Lilly P.R. for the trade package. Effective January 1, 1973, the distribution agreement was amended to provide that petitioner would reimburse Lilly P.R. for its costs of manufacturing Darvon and Darvon-N products used as samples by petitioner. That provision was effectuated by Lilly P.R. granting petitioner chargebacks for Darvon and Darvon-N products used as samples equal to Lilly P.R.'s manufacturing profit for such products.

In 1973, Lilly P.R. manufactured and sold to petitioner Ilosone products, the pricing of which is in dispute but has been severed from the trial of this case. Lilly P.R. also manufactured and sold a small amount of certain other pharmaceutical products in 1971, 1972, and 1973, the pricing of which is not in dispute in this case. In addition, in late 1973, Lilly P.R. manufactured and sold to petitioner Darvocet-N 100 (TA 1893), but that product was not sold by petitioner until 1974.

B. *Initial Pricing Policy*

In 1965, petitioner's second project team for Puerto Rico decided that Lilly P.R.'s prices to petitioner should allow petitioner to recover its selling and distribution expenses related to Lilly P.R. products and to earn a profit equal to 90 to 100 percent of those expenses. In accordance with that decision, Lilly P.R.'s prices to petitioner for Darvon products initially were established at a 35-percent discount from petitioner's net wholesale prices for those products.

Lilly P.R.'s prices to petitioner for Darvon products were reduced for 1967 and 1968 to petitioner's net wholesale prices, less a 40-percent discount. That action was taken in order to conform Lilly P.R.'s prices with the objective of providing petitioner with operating income equal to 90 to 100 percent of its selling and distribution expenses related to those products.

During the period from late 1969 through February 1972, the Service audited petitioner's returns for the 1966 through 1968 taxable years. As a result of that audit, the Service and petitioner agreed upon certain allocations of income from Lilly P.R. to petitioner on the basis of adjustments to the transfer price of Darvon products sold to petitioner by Lilly P.R. in 1966 and 1967. For the taxable year 1968, the Service and petitioner agreed to a pricing formula for Darvon products (hereinafter the 1968 audit formula), the result of which was to divide the combined profit earned by Lilly P.R. and petitioner and to use such division for purposes of establishing the price at which Darvon products should be sold by Lilly P.R. to petitioner.

The first step in the application of the 1968 audit formula was a determination of the combined net income of petitioner and Lilly P.R. attributable to the intangible property related to the manufacture and sale of Darvon products. The combined net income attributable to intangibles was determined by subtracting from the total combined net income of petitioner and Lilly P.R. from the manufacture and sale of Darvon products (a) a manufacturing profit equal to 100 percent of Lilly P.R.'s manufacturing costs (i.e., cost of goods sold) less Lilly P.R.'s operating expenses; (b) the cost savings resulting from operating in Puerto Rico rather than in the United States; and (c) a marketing profit equal to 25 percent of petitioner's expenses attributable to its marketing of Darvon products in the United States. The location savings portion of the formula represented the reduced cost of operating in Puerto Rico as compared to the United States and was attributable primarily to lower labor rates in Puerto Rico and Lilly P.R.'s exemptions from Puerto Rican property and other non-income taxes.

Under the 1968 audit formula, 60 percent of the net income attributable to intangibles was considered as being attributable to manufacturing intangibles such as the propoxyphene patent and propoxyphene manufacturing know-how and was allocated to Lilly P.R. The remaining 40 percent of the net income attributable to intangibles was considered to be attributable to marketing intangibles, such as the Darvon trademark and petitioner's name and marketing organization, and was allocated to petitioner.

On April 12, 1972, petitioner and the Service entered into a closing agreement for the 1966 through 1968 taxable years, reflecting the adjustments referred to above. As stated, the 1968 audit formula was applied to 1968 only; an alternative method of disposing of the 1966 and 1967 years was agreed to by the Service and petitioner. Petitioner and respondent at no time entered into an agreement that would legally bind the other party to apply the 1968 audit formula to the years 1971 through 1973.

C. *Pricing Policy 1971–73*

On June 30, 1972, petitioner and Lilly P.R. amended their distribution agreement in order to adjust Lilly P.R.'s prices for Darvon and Darvon-N products. The discount from petitioner's net wholesale prices on Darvon and Darvon-N products was increased from 40 percent to 46 percent effective July 1, 1972. That amendment to the distribution agreement provided, in pertinent part:

> WHEREAS, [petitioner] has agreed with the Internal Revenue Service that the price [petitioner] will pay for DARVON® Products manufactured by [Lilly P.R.] cannot exceed certain guidelines; and
>
> WHEREAS, it has been understood between the two companies that as soon as a preliminary analysis of 1972 results provided some indication that prices paid for DARVON® Products were not within such guidelines, adjustments would be made to correct prior pricing for such Products purchased on or after January 1, 1972, and to establish new intercompany prices for the remainder of 1972; and
>
> WHEREAS, it is now apparent that prices charged [petitioner] for DARVON® Products during the period January 1, 1972, through June 30, 1972, exceed the agreed upon guidelines, and that to keep the prices paid for DARVON® Products within the guidelines for the remainder of 1972, it will be necessary to increase discounts to [petitioner] as set forth in the attached price schedule.

In February 1972, as the expiration of the propoxyphene patent on December 27, 1972, approached, petitioner began to consider Lilly P.R.'s pricing of Darvon and Darvon-N products for 1973. Such consideration consisted of several discussions involving officers of petitioner and petitioner's outside tax advisers.

Petitioner's consideration of the 1973 pricing of Lilly P.R.'s Darvon and Darvon-N products was conducted in the context of the 1968 audit formula. Because the propoxyphene patent

would no longer be in existence in 1973, petitioner's objective was to determine what intangible property would remain in Lilly P.R. in 1973 and the value of that property. In that respect, petitioner considered the alternative of Lilly P.R. selling directly to wholesalers in the United States, accompanied by the transfer of the Darvon and Darvon-N trademarks to Lilly P.R. Petitioner rejected that alternative in 1972 as it had in 1965 and 1966.

Petitioner determined that, after the expiration of the propoxyphene patent, three intangible elements would remain in Lilly P.R. Those elements were: (a) Manufacturing know-how, (b) the glutamic acid hydrochloride formula for Darvon compound products, and (c) the napsylate patent.

Petitioner believed that the 100-percent markup allowed Lilly P.R. under the 1968 audit formula probably included compensation to Lilly P.R. for such things as capital investment, going concern value, and goodwill. However, petitioner believed that the 100-percent markup did not allow Lilly P.R. sufficient compensation for the manufacturing know-how that had been developed over the years by Lilly P.R. and petitioner. The manufacturing cost of Darvon products as a percentage of sales historically had declined from a high of 28.2 percent to 13.9 percent, a 14 percentage point difference. Petitioner assumed that part of that cost reduction was attributable to increases in volume and to the savings attributable to operating in Puerto Rico rather than in the United States. Accordingly, petitioner concluded that only 6.9 percent of the 14 percentage point difference was properly attributable to manufacturing know-how. Assuming sales to wholesalers of Darvon and Darvon-N products of $70 million, petitioner concluded that between $4.5 million and $5 million of income was attributable to Lilly P.R.'s manufacturing know-how.

Petitioner also believed that the glutamic acid hydrochloride formula used by Lilly P.R. in the manufacture of Darvon products containing aspirin had a significant intangible value. That formula allowed Lilly P.R. to make a stable product that was difficult to abuse. Petitioner believed that it was reasonable to attribute a 3-percent royalty value to that formula. Because the Darvon products using that formula respresented approximately 65 percent of $54 million of petitioner's total sales of Darvon and Darvon-N products, petitioner estimated

that approximately $2 million of income was attributable to the glutamic acid hydrochloride formula.

Petitioner also considered the napsylate patent to be a valuable intangible that would remain in Lilly P.R. in 1973. Sales of Darvon-N products were projected to be approximately 15 to 20 percent of total sales of propoxyphene products in 1973, and total income for 1973 attributable to intangibles under the 1968 audit formula was projected to be $30 million. Petitioner concluded that it was reasonable to attribute to the napsylate patent between 5 to 10 percent or $1.5 to $3 million of the total income attributable to intangibles.

In summary, petitioner concluded that $8 to $10 million of income could be attributable to the intangibles remaining in Lilly P.R. in 1973. As the income attributable to all intangibles under the 1968 audit formula was projected to be approximately $30 million, petitioner concluded that approximately 30 percent[30] of that intangible value could be allocated to Lilly P.R. for the purpose of determining Lilly P.R.'s prices to petitioner for Darvon and Darvon-N products. Thus, in applying the 1968 audit formula to the 1973 taxable year, petitioner allocated to Lilly P.R. 30 percent of the income attributable to intangibles, rather than 60 percent as in prior years. The distribution agreement between Lilly P.R. and petitioner accordingly was amended to increase the discount from net wholesale prices for Darvon and Darvon-N products from 46 percent to 58 percent, effective January 1, 1973.

XII. *Financial Information*

A. *Overview of Petitioner's Accounting System*

[30] Petitioner's calculation, as we have deduced it from the record, was as follows:

	In millions of dollars	
	Minimum	*Maximum*
Manufacturing know-how	4.5	5
Glutamic acid hydrochloride	2	2
Napsylate patent	1.5	3
	8.0	10
Expressed as a percentage of $30 attributable to intangibles	26.6%	33.3%
Average of minimum and maximum	29.9%	

Petitioner's financial statements for the years 1971 through 1973 were a consolidation of the financial records of petitioner and its subsidiaries, including Lilly P.R.

Petitioner and each of its subsidiaries accounted for expenses on a departmental basis. Petitioner maintained a departmental accounting system, with every individual who worked for petitioner assigned to a specific department.

In the departmental accounting system, petitioner maintained three primary groupings of departments and accounts: manufacturing, operating, and service. Petitioner's manufacturing departments worked directly on the manufacture of a product. The accounting for expenses of manufacturing departments was accomplished by establishing cost center rates within each department which were then applied to the product flowing through the department on the basis of time spent or on an absorption-rate basis. When the product was completed, it was placed in inventory. When the product was ultimately sold, it was released from inventory, and its cost was charged to manufacturing cost of sales.

The second grouping was petitioner's nonmanufacturing operating departments. The expenses of those departments were recorded in several separate subledgers such as selling, merchandising, shipping, research and development, and general administration.

The third primary grouping consisted of those departments of petitioner that serviced other departments. The service departments included quality control, engineering, personnel, buildings and ground maintenance, and industrial relations. The expenses of those departments were recorded in service ledger accounts and ultimately were allocated either to a manufacturing cost account or to an operating expense account.

B. *Lilly Research Laboratories' Accounting Systems*

Lilly Research Laboratories had two separate but closely related accounting systems: a general departmental accounting system and a project accounting system.

The general departmental accounting system accumulated costs by expense class (e.g., compensation and benefits, supplies, and materials) for each department in Lilly Research Laboratories. Under the project accounting system, expenses

were recast from a departmental basis to a research project basis which enabled petitioner to track, monitor, and manage the various research projects of Lilly Research Laboratories. The system also provided the management of Lilly Research Laboratories with information to assist it in establishing priorities for and planning and control of research activities.

As stated earlier, Lilly Research Laboratories had a general research project for each broad area of interest to petitioner, such as anti-cancer drugs, cardiovascular drugs, and analgesic drugs. Each of those projects was monitored by a research project committee. Projects in the general research area had "RP" numbers, that is, research project numbers.

Generally, when a promising compound was identified by one of the research projects, a product development or "PD" number was established for the new compound.[31] Thereafter, the research activity carried out with respect to the new compound was to be charged to its PD number rather than to a general RP number. A development project team also was established at that time to monitor the particular project.

There were two basic methods for allocating expenses in the project accounting system. The simplest method was the direct charging method. Certain expenditures, such as materials bought specifically for a particular research project could be identified with and directly charged to specific projects. The determination of which project to charge was not an accounting function but was made by research management personnel. The second method of charging expenses to research projects was based on research time reports. The scientific personnel of Lilly Research Laboratories filled out time sheets on a monthly basis. Those time sheets showed the projects to which the employee charged time the previous month, and contained space for the addition of new projects in the current month. The employee was required to allocate to those projects his total time on the job that month. The total time allocated by all employees to each one of the projects was accumulated at the end of each month. The expenses of each department,

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[31] RP 1638 (propoxyphene hydrochloride and acetaminophen), established for the purpose of developing the product Darvocet, appears to be an exception to this rule. Petitioner has failed to explain the disparity in treatment of Darvocet and other products. Also, no PD number was established for Darvon-N products until 1967, although propoxyphene napsylate was identified and the patent was approved in the early 1960's.

other than those expenses directly charged to projects, were allocated to the various projects based on the time spent on the projects by the employees in that department. The expenses allocated included compensation, benefits, overhead, and utilities.

As a general rule, only the technicians and scientists, that is, the professional researchers working directly on research projects, filled out time sheets. Senior scientists and research management people normally did not fill out time sheets, as they tended to be involved more in supervisory or administrative functions, and their time was allocated on the basis of the time of the people they supervised. The support staff (e.g., secretaries, animal caretakers, and clerical help) also did not fill out time sheets. During the years 1971 through 1973, approximately 800 persons filled out time sheets. There were approximately 1,700 employees in Lilly Research Laboratories (exclusive of the control division) in those years, so approximately 45 to 50 percent of the research and development personnel filled out time sheets.

The Lilly Research Laboratories project accounting system has been in existence since at least 1951. Since that time, there have been no significant changes in the system of reporting time and direct charging of expenses to projects. There have been some refinements and enhancements over the years, however, such as the establishment of more, and more specific, project numbers; the direct charging of clinical grants to the related project; more frequent reporting of time; and computerization.

C. *Propoxyphene Research and Development Expenses*

1. *Pre-1967 Research Activities*

For the period 1951 through 1966, the total expenses of Lilly Research Laboratories relating to propoxyphene, by project number, were as follows (000's omitted):

Research project	*1951–57*	*1958–66*	*Total 1951–66*
RP 1195 Analgesics General	$848	$765	$1,613
RP 1513 Propoxyphene	0	14	14
PD 1464 Darvon & Novrad	0	797	797
PD 1627 Darvo-Tran	0	6	6

Research project	*1951–57*	*1958–66*	*Total 1951–66*
PD 2204 Stero-Darvon	$0	$604	$604
Propoxyphene	0	54	54
Price list items	0	41	41
Compound 31518 Darvon Analog	0	39	39
	848	2,320	3,168

During the period 1951 through 1957, there were no PD project numbers for propoxyphene in existence, and only one analgesic project. Therefore, all the propoxyphene activity reported was captured by RP 1195. However, other non-propoxyphene analgesic activity also was charged to RP 1195 during those years, although petitioner is unable to quantify that non-propoxyphene activity in RP 1195.

The propoxyphene expenses for 1951 through 1957 contained in RP 1195 did not include clinical grants to outside investigators relative to propoxyphene products because grants were not charged directly to specific projects during that period. Petitioner's total clinical grants, including propoxyphene-related grants, during 1951 through 1957 averaged approximately $200,000 per year or 2 to 3 percent of petitioner's total research and development expenditures. Petitioner is unable to identify specifically the propoxyphene-related clinical grants for those years.

In 1958, research management at Lilly Research Laboratories established additional project numbers for Darvon products in order to isolate propoxyphene expenses from the rest of the general analgesic research. However, RP 1195 continued to include both some propoxyphene and non-propoxyphene research activity; petitioner again is unable to quantify that non-propoxyphene activity in RP 1195. No propoxyphene research was charged to RP 1195 after 1962.

The propoxyphene expenses for 1958 through 1966 did not include clinical grants relative to propoxyphene products because, during that period, grants again were not charged directly to specific projects. Petitioner's total clinical grants, including propoxyphene-related grants, during 1958 through 1966 averaged approximately $800,000 to $1 million per year, or 3 to 4 percent of total research and development expenditures. Petitioner is unable to identify specifically the propoxyphene-related grants for those years.

2. *1967–73 Research Activities*

In 1968, pursuant to the joint research agreement between Lilly P.R. and petitioner, Lilly P.R. began reimbursing petitioner for certain research and development expenses relative to Darvon and Darvon-N products. The following amounts were billed by petitioner to Lilly P.R. for research performed during the calendar years 1967 through 1973. In 1973, the amount billed included Ilosone-related research performed in 1973.

Year billed	*Amounts of petitioner's research and development expenses billed to Lilly P.R.*
1968	$419,986
1969	485,890
1970	505,156
1971	506,937
1972	661,197
1973	891,963
Total	3,471,129

The research and development expenses billed by petitioner to Lilly P.R. were the expenses attributed by Lilly Research Laboratories' project accounting system to those research projects and clinical grants[32] related to products manufactured by Lilly P.R., including Darvon and Darvon-N products. The expenses incurred in any 6-month period attributed to such products and grants were billed to Lilly P.R. during the following 6-month period. For example, expenses incurred by petitioner during the last 6 months of 1972 were billed to Lilly P.R. during the first 6 months of 1973. Research and development expenses shown on the books and records of Lilly P.R. generally exceeded in any year the research and development expenses billed to Lilly P.R. by petitioner because Lilly P.R. charged to research and development expense the expenses of producing materials for use in the research activities of

[32] Prior to 1970, the project accounting system did not charge clinical grants directly to research projects. For the years 1967 through 1969, petitioner reviewed the clinical grants records of Lilly Research Laboratories to determine which clinical grants properly were attributable to Darvon and Darvon-N products. Petitioner billed Lilly P.R. for the costs of the grants it so identified. From 1970 through 1973, all clinical grants determined by petitioner to be attributable specifically to Darvon and Darvon-N products were charged directly to such projects, and thus billed to Lilly P.R., in accordance with the project accounting system.

petitioner and the expenses of research related activities of Lilly P.R.

The research and development expenses of Lilly Research Laboratories billed to Lilly P.R. during the years 1968 through 1973 were attributable to the following research and product development projects, clinical grants, and materials:

Project number	*Description*	*Total*
PD 1464	Darvon & Novrad	$526,137
PD 1627	Darvo-Tran	3,003
PD 2204	Stero-Darvon with A.S.A.	70,368
PD 2308	Actimets Darvon (1971–73)	195,051
PD 3012	Darvon-N & Combination Products	1,708,055
PD 3016	Sphercotes Darvon	357,267
RP 1638	Darvocet	136,750
0805	Pulvules Darvon	7,144
0694	Pulvules Darvo-Tran	7,250
PD 1544	Ilosone	180,228
	Grants (1967–69)	245,845
	Materials	34,031
		3,471,129

D. *Lilly P.R. Financial Statements 1971–73*

For the years 1971 through 1973, Lilly P.R.'s statement of income, as reflected in its Ernst & Ernst audited financial statements, was as follows:

	1971	*1972*	*1973*
Net sales to affiliated companies	$55,573,774	$57,188,297	$50,785,895
Cost of goods sold	12,754,744	14,387,345	18,669,170
	42,819,030	42,800,952	32,116,725
Expenses:			
Administrative and general	1,316,108	1,075,313	1,241,112
Samples	1,042,215	1,297,190	194,762
Research and development	522,891	712,633	929,849
	2,881,214	3,085,136	2,365,723
	39,937,816	39,715,816	29,751,002
Other income:			
Interest on certificates of deposit	2,503,034	2,890,985	7,091,162
Income from Government guaranteed securities	2,176,049	2,101,277	2,465,225
Sundry	16,270	42,951	50,207
	4,695,353	5,035,213	9,606,594
	44,633,169	44,751,029	39,357,596

	1971	1972	1973
Other deductions:			
Prior years' price adjustments		$30,780,507	$5,826,399
Amortization of bond premiums and bank fees	$103,573	84,450	37,693
Idle plant cost	35,145	- - -	- - -
Sundry	35,294	21,828	30,569
	174,012	30,886,785	5,894,661
Income before income taxes	44,459,157	13,864,244	33,462,935
Income taxes:			
Puerto Rico	594,045	(560,816)	845,873
Federal	166,034	139,964	218,882
	760,079	(420,852)	1,064,755
Net income	43,699,078	14,285,096	32,398,180

The Forms 1120 filed by Lilly P.R. for the years 1971 through 1973 report tax-exempt possession source income in the following amounts:

Year	Exempt possession source income
1971	$40,914,829
1972	42,037,274
1973	36,537,408

For the years 1971 through 1973, Lilly P.R.'s balance sheet, as reflected in its Ernst & Ernst audited financial statements, was as follows:

ASSETS

	At December 31—		
	1971	1972	1973
Current assets			
Cash	$654,639	$353,196	$1,220,930
Certificates of deposit	41,300,000	85,700,000	107,700,000
Government securities	88,993,655	62,884,710	70,600,000
Accounts receivable:			
Affiliated companies	28,498,967	24,358,172	21,166,295
Interest	1,459,565	2,155,520	2,771,120
Other	37,756	634,333	160,516
	29,996,288	27,148,025	24,097,931
Inventories:			
Finished	65,509	13,166	307,361
Work in process	2,141,997	1,206,419	2,220,854
Raw materials	4,788,151	3,795,136	5,348,207

	At December 31—		
	1971	*1972*	*1973*
Packaging	$264,858	$387,476	$696,536
Supplies	275,082	434,258	505,289
	7,535,597	5,836,455	9,078,247
Total current assets	168,480,179	181,922,386	212,697,106
Prepaid expenses and other assets	191,212	195,525	196,427
Property, plant, and equipment:			
Buildings	11,718,630	11,787,169	13,945,669
Machinery and equipment	9,046,290	9,609,287	11,480,357
	20,764,920	21,396,456	25,426,026
Allowances for depreciation	(3,436,701)	(4,445,457)	(5,671,741)
	17,328,219	16,950,999	19,754,285
Land	998,541	978,756	978,756
Construction	445,126	1,841,819	522,744
	18,771,886	19,771,574	21,255,785
	187,443,277	201,889,485	234,149,320

LIABILITIES

	At December 31—		
	1971	*1972*	*1973*
Current liabilities			
Accounts payable:			
Parent company	$471,489	$617,010	$70,909
Other	493,488	424,832	533,472
	964,977	1,041,842	604,381
Accrued payrolls, payroll taxes and amounts witheld from payrolls	319,145	485,523	595,912
Other accrued expenses	17,020	16,182	28,713
Taxes on income:			
Puerto Rico	103,757	. . .	. . .
Federal	10,759	33,223	103,857
	450,681	534,928	728,482
Total current liabilities	1,415,658	1,576,770	1,332,863
Stockholder's equity			
Common stock, no par value: Authorized, issued, and outstanding 1,000 shares at stated capital amount (no change)	500,000	500,000	500,000
Reinvested earnings	185,527,619	199,812,715	232,316,457
	186,027,619	200,312,715	232,816,457
	187,443,277	201,889,485	234,149,320

E. *Lilly P.R. Sales of Darvon and Darvon-N Products*

Lilly P.R.'s sales of each Darvon and Darvon-N product marketed by petitioner during the years 1971 through 1973, expressed as percentages of Lilly P.R.'s total sales of Darvon and Darvon-N products to petitioner during those years, were as follows:

Identification code	*Description*	*1971*	*1972*	*1973*	*Total 1971–73*
PU 364	Darvon 32 mg.	1.6%	1.1%	1.4%	1.4%
PU 365	Darvon 65 mg.	20.5	22.8	15.2	19.9
PU 366	Darvon with A.S.A.	3.1	2.1	2.0	2.5
PU 368	Darvon Compound	2.3	1.8	2.2	2.1
PU 369	Darvon Compound-65	60.7	60.6	50.7	58.6
PU 377	Darvo-Tran	1.2	1.0	1.0	1.1
TA 1855	Stero-Darvon	0.5	0.4	0.6	0.5
TA 1883	Darvon-N	3.8	3.9	8.7	4.9
TA 1884	Darvon-N with A.S.A.	5.7	4.0	8.1	5.6
MS 135	Darvon-N Suspension	0.6	0.2	(0.3)	0.3
TA 1890	Darvocet-N 50	- - -	2.1	10.4	3.1
	Totals	100.0	100.0	100.0	100.0

F. *Petitioner's Pharmaceutical Division Income Statements*

Petitioner's accounting records for sales were maintained on the basis of two divisions, Elanco and the parent (pharmaceutical division). The Elanco division conducted the marketing and sale of animal health and agricultural products while the pharmaceutical division conducted all petitioner's pharmaceutical operations in the United States, including research and development. All petitioner's expenses were charged to one or the other of those two divisions.

For the years 1971 through 1973, the operating income of petitioner's pharmaceutical division was as follows:

	1971	*1972*	*1973*
Net sales	$338,321,035	$351,043,948	$368,914,571
Cost of goods sold	135,365,180	135,781,325	136,096,900
Gross profit	202,955,855	215,262,623	232,817,671
Operating expenses:			
Merchandising	29,449,279	25,492,164	27,508,217
Selling	31,927,371	33,844,269	39,377,260
Shipping	8,586,038	9,658,004	11,243,576
General administrative	31,739,849	35,068,693	38,018,471
Loss on returned goods	2,600,054	3,076,367	3,324,777
Total operating expenses	104,302,591	107,139,497	119,472,301
Operating income	98,653,264	108,123,126	113,345,370

The operating income statement above was not prepared contemporaneously with the years 1971 through 1973, but the information contained therein was derived from the contemporaneous financial records of petitioner.

Net sales, cost of goods sold, and gross profit of the pharmaceutical division represented the entire activitiy of petitioner, exclusive of the Elanco division and those charges that were directly incurred on behalf of sales to petitioner's international operations.

Merchandising and selling expenses of the pharmaceutical division included all expenses of petitioner's merchandising and selling departments assigned to the pharmaceutical division. Excluded from those expenses were the merchandising and selling expenses of departments of the Elanco division, which were incurred directly by that division and charged to its separate general ledger.

Shipping expenses of the pharmaceutical division included principally freight and warehousing. Those expenses were not reported through either the pharmaceutical or Elanco division but rather through the corporate division. The shipping department maintained records of all freight charges and those charges were assigned directly to the proper division based on the nature of the product being shipped. With respect to warehousing, if a facility was used exclusively for a product of either the pharmaceutical or Elanco division, then the cost of the facility was charged directly to such division. If, however, the facility was jointly used, the cost was allocated to the divisions on the basis of the floor space utilized.

General administrative expenses of the pharmaceutical division included the expenses of petitioner's corporate affairs, financial, legal, and data processing departments, plus the expenses of petitioner's top management and all management of the pharmaceutical division. General administrative expenses were gross figures and were not net of administrative and technical service fees from petitioner's subsidiaries, which were booked as "other income," a nonoperating income item.

Also included in the general administrative expenses of petitioner's pharmaceutical division were the activities and services performed for Lilly P.R. which petitioner considered to be stewardship expenses. The following activities were not billed to Lilly P.R. but were charged to general administrative

expense: (a) Services performed for Lilly P.R. by petitioner's corporate tax, legal,[33] corporate insurance, accounting, and financial departments; (b) activities performed in Indianapolis[34] on Lilly P.R. matters by any member of petitioner above the level of assistant division director;[35] and (c) periodic audits, conducted every 12 to 18 months by petitioner's quality assurance department.

During the years in issue, Lilly P.R. had the use of manuals prepared by petitioner in its manufacturing and other operations. The manuals were provided to Lilly P.R. without its reimbursing petitioner for the cost of preparing the manuals. Petitioner charged the cost of developing the manuals to general administrative expenses, but did not specifically delineate them as stewardship expenses.

Loss on returned goods for the pharmaceutical division represented products returned from the field, principally from outdating where the product in the field exceeded its expiration date. Petitioner's returned goods experience with respect to Darvon and Darvon-N products historically has been very favorable due to the products' long dating period and rapid shelf turnover.

G. *Combined Income Statements for Darvon and Darvon-N Products 1971–73*

1. *General*

During the normal course of its business, petitioner did not maintain accounting records that reflected net income for the pharmaceutical division or by various product lines. During the years 1971 through 1973, petitioner contemporaneously prepared consolidated net income statements (hereinafter the combined income statements) for all products, including Darvon and Darvon-N, manufactured and sold by Lilly P.R. Those combined income statements were prepared to enable petitioner's management to determine and evaluate the intercompany transfer prices for products sold by Lilly P.R. to petitioner.

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[33] See e.g., pp. 1072–1073 *supra*.

[34] If the employees traveled to Puerto Rico, however, their time as well as their travel expenses were billed to Lilly P.R.

[35] Those activities included the serving of petitioner's employees on Lilly P.R.'s board of directors, as all the employees so serving were above the level of assistant director.

The combined income statements of petitioner and Lilly P.R. for the years 1971 through 1973 with respect to Darvon and Darvon-N products were as follows:

1971

	Lilly P.R.	*Petitioner*		
	Sales to petitioner	*Sales to Lilly P.R.*	*Sales of Lilly P.R. produced merchandise*	*Total*
Net sales	$53,968,400	$654,833	$73,861,799	$74,516,632
Cost of goods sold	11,569,396	381,102	47,059,792	47,440,894
Gross profit	42,399,004	273,731	26,802,007	27,075,738
Adjustment for change in inventory	(6,258,854)	(140,258)	---	(140,258)
Adjusted gross income	36,140,150	133,473	26,802,007	26,935,480
Operating expense:				
Research & development	522,891	---	---	---
General administration	1,295,050	31,159	1,204,177	1,235,336
Selling	---	---	4,150,558	4,150,558
Merchandising	---	---	3,898,811	3,898,811
Shipping	---	---	551,898	551,898
Sample expense	1,041,308	---	---	---
Total operating expense	2,859,249	31,159	9,805,444	9,836,603
Operating income	33,280,901	102,314	16,996,563	17,098,877
Other income:				
Royalties	---	86,687	---	86,687
Net income	33,280,901	189,001	16,996,563	17,185,564

1972

	Lilly P.R.	*Petitioner*		
	Sales to petitioner	*Sales to Lilly P.R.*	*Sales of Lilly P.R. produced merchandise*	*Total*
Net sales	$54,793,500	$603,140	$75,827,232	$76,430,372
Cost of goods sold	12,697,303	374,591	46,686,723	47,061,314
Gross profit	42,096,197	228,549	29,140,509	29,369,058
Adjustment for change in inventory	(6,984,591)	77,921	---	77,921
Adjusted gross income	35,111,606	306,470	29,140,509	29,446,979
Operating expense:				
Research & development	712,633	---	---	---
General administration	1,048,430	31,413	1,530,354	1,561,767
Selling	---	---	6,331,787	6,331,787
Merchandising	---	---	4,082,419	4,082,419
Shipping	---	---	516,894	516,894
Sample expense	1,234,433	---	---	---

	Lilly P.R.	Petitioner		
	Sales to petitioner	Sales to Lilly P.R.	Sales of Lilly P.R. produced merchandise	Total
Total operating expense	$2,995,496	$31,413	$12,461,454	$12,492,867
Net income	32,116,110	275,057	16,679,055	16,954,112

1973

	Lilly P.R.	Petitioner		
	Sales to petitioner	Sales to Lilly P.R.	Sales of Lilly P.R. produced merchandise	Total
Net sales	$32,598,070	$429,394	$70,026,591	$70,455,985
Cost of goods sold	10,739,954	258,897	38,387,726	38,646,623
Gross profit	21,858,116	170,497	31,638,865	31,809,362
Adjustment for change in inventory	5,549,170	203,114	- - -	203,114
Adjusted gross income	27,407,286	373,611	31,638,865	32,012,476
Operating expense:				
Research & development	749,621	- - -	- - -	- - -
General administration	845,197	20,751	2,175,799	2,196,550
Selling	- - -	- - -	8,025,582	8,025,582
Merchandising	- - -	- - -	[1]6,378,561	6,378,561
Shipping	- - -	- - -	498,587	498,587
Total operating expense	1,594,818	20,751	17,078,529	17,099,280
Net income	25,812,468	352,860	14,560,336	14,913,196

[1]Includes sample expense of $1,872,896.

2. *Lilly P.R.*

Lilly P.R.'s net sales were computed by abstracting from invoices its gross sales less returns and chargebacks. The adjustment for change in inventory was computed by petitioner to remove from the combined income statements any intercompany profit or loss on Lilly P.R.'s sales to petitioner. Lilly P.R.'s general administration expenses were allocated as a percentage of sales, and research and development expenses were calculated in accordance with the joint research agreement.

3. *Petitioner*

Petitioner's net sales, cost of goods sold, and gross profit on the combined income statements were taken directly from the audited books and records of petitioner's pharmaceutical division and no allocations were made.

a. *Cost of Goods Sold*

Cost of goods sold included the transfer or invoice price from Lilly P.R., plus pro rata shares of the actual freight and insurance expenses associated with bringing the goods from Puerto Rico to Indianapolis. In 1971, none of the expenses of petitioner's ticket issuance and stock planning departments were included in petitioner's cost of goods sold of Darvon and Darvon-N products. In 1972 and 1973, cost of goods sold included some portion of the expenses of those departments.

The total department expenses of petitioner's ticket issuance department were $285,000, $300,000, and $311,000 in 1971, 1972, and 1973, respectively. In 1972 and 1973, 5 percent ($15,000) and 7 percent ($22,000), respectively, of the expenses of petitioner's ticket issuance department were charged to and included in petitioner's cost of goods sold of Darvon and Darvon-N products. The percentages of ticket issuance expenses charged to cost of goods sold of Darvon and Darvon-N products were based on the ratio of the number of manufacturing tickets for Darvon and Darvon-N products issued to Lilly P.R. over the total number of manufacturing tickets issued during each year.

The total department expenses of petitioner's finished stock planning department were $438,000, $425,000, and $450,000 in 1971, 1972, and 1973, respectively. In 1972 and 1973, 12 percent ($51,000) and 14 percent ($63,000), respectively, of those expenses were charged to and included in petitioner's cost of goods sold of Darvon and Darvon-N products. The percentages of finished stock planning expenses charged to Darvon and Darvon-N cost of goods sold were based on the ratio of the number of persons handling all Puerto Rico source products to the total number of persons in the finished stock planning department.

b. *Operating Expenses*

i. *General Administration Expenses*

In allocating general administrative expenses, petitioner first obtained the total general administrative expenses for its 1971, 1972, and 1973 pharmaceutical division from its consolidated financial statements. Petitioner then arrived at an "administrative expense factor," which was the percentage of total general administrative expenses relative to certain total expenditures of petitioner. The denominator of that fraction included manufacturing costs less material costs, research and development expenses, and selling, merchandising, and shipping expenses of petitioner. The next step was to total the various expenses that previously had been directly incurred or allocated in the combined income statements, i.e., the selling, merchandising, and shipping expenses. The administrative expense factor percentage then was applied to those expenses, which resulted in a total administrative expense allocable to Darvon and Darvon-N products.

ii. *Selling Expenses*

For 1971, petitioner's selling expenses were allocated to Darvon and Darvon-N products on the basis of the ratio of primary details of those products to total primary details.[36] The method of allocating selling expenses used by petitioner for the years 1972 and 1973 was as follows.

Petitioner's selling expenses were first analyzed by segregating total calls by sales representatives into six categories. Each sales representative of petitioner reported on a daily call card the number and types of calls he made on various health care representatives. The total calls of the sales representative were categorized as follows: physicians, interns, and residents; drug stores; hospitals; nonmedical; dentists; and miscellaneous. The total number of calls and a percentage of total calls were determined for each category.

The total U.S. selling expenses of petitioner's pharmaceutical division, less selected accounts,[37] then were extracted from the general ledger. That total was multiplied by the percentage factor for each call category to arrive at the total amount of selling expenses for all products properly attributable to each particular category of calls.

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[36] See p. 1054 for the meaning of primary details.

[37] The record is silent as to what those accounts were in 1972. In 1973, the total pharmaceutical division selling expenses were reduced only by the expenses of the Dista sales force.

The next step was a determination of the proper allocation factor or percentage for each call category as it related to Darvon and Darvon-N products. The allocation factor then was multiplied against the total amount of selling expenses for each category to determine the proper Darvon/Darvon-N allocation.

The first type of call category, physicians, interns, and residents, involved calls on physicians, interns, and residents at their private offices or in hospitals. Those calls were allocated on the basis of annual primary detail calls made by petitioner's sales representatives on physicians, interns, and residents for Darvon and Darvon-N products as a percentage of total primary detail calls for all of petitioner's products. The number of such annual primary detail calls was ascertained from the internal call data reports submitted by the sales representatives to petitioner's marketing department. Primary detail calls represented the most reliable information to measure selling activity for physician, intern, and resident calls.

The next category, drug store calls, was determined by reference to petitioner's price list for its top 100 items (based on sales). The top 100 items represented 92 percent of petitioner's pharmaceutical products sold for 1973. Petitioner determined that, according to the price list, sales of Darvon and Darvon-N products represented 10 percent of the total number of sales of the top 100 items. Accordingly, a 10-percent allocation factor was applied for drug store calls. Petitioner used that methodology to allocate drug store calls because that type of call was essentially a service call on the pharmacist and, unlike calls on physicians, did not relate to any specific product.

Hospital calls involved calls on hospital pharmacists. Those calls were allocated on the basis of total Darvon and Darvon-N products sales to hospitals as a percentage of total pharmaceutical sales by petitioner to hospitals. Because petitioner had no actual data on sales of its products to hospitals, because it sold only to wholesalers, the data for that method were derived from an external independent audit conducted by International Marketing Services (hereinafter IMS). The audit was based on a significant statistical sample, and IMS used techniques that petitioner believed provided a good representation of the

movement of products from the wholesaler to the hospital. Petitioner believed the IMS data to be accurate and reliable.

Nonmedical calls involved calls in a hospital atmosphere on nonphysician health care individuals, such as hospital administrators or nurses. As with hospital calls, the percentage allocation factor was determined on the basis of total sales of Darvon and Darvon-N products to hospitals as a percentage of total pharmaceutical sales by petitioner to hospitals. Therefore, the source of data used for the allocation was again the IMS audit.

Dentist calls involved calls by petitioner's sales representatives on privately practicing dentists in their offices. Petitioner's methodology was to calculate total Darvon and Darvon-N prescription dollars as a percentage of petitioner's total dental prescription dollars to arrive at an expense allocation for Darvon and Darvon-N products. Because petitioner had no internal records regarding dental prescriptions, it again used data derived from an external independent audit. The audit used was the R.A. Gosselin Prescription Audit (hereinafter the Gosselin audit). Whereas the IMS audit was a breakdown of retail sales, primarily to hospitals, the Gosselin audit was an audit of actual prescription activity. Petitioner believed the Gosselin data to be accurate and reliable.

Miscellaneous calls involved calls by petitioner's sales representatives on industrial clinics; pharmacy, dental, and medical schools; and nursing homes. The methodology used to arrive at an allocation factor for miscellaneous calls was to calculate petitioner's total sales of Darvon and Darvon-N products to wholesalers as a percentage of petitioner's total sales of pharmaceutical products to wholesalers. The data for that allocation were generated internally.

The final item of allocation of selling expenses was administrative support. Administrative support represented expenditures exclusive of direct selling, such as sales management, district and regional sales directors, secretarial support, and sales service training. The methodology used to determine the allocation factor was the same as that used for miscellaneous calls, that is, the percentage factor was calculated based on petitioner's total sales of Darvon and Darvon-N products to wholesalers as a percentage of petitioner's total pharmaceuti-

cal sales to wholesalers. The data for that allocation also were internally generated.

iii. *Merchandising Expenses*

Petitioner's allocation of merchandising expenses in the combined income statements was first determined by identifying the total merchandising expenses reported on the books and records of petitioner's pharmaceutical division as accumulated in its consolidated financial statements for the years 1971, 1972, and 1973. Those figures were comprised of direct promotion expenses and indirect merchandising expenses.

The direct promotion expenses were those expenses directly related to particular product groups. At the time such expenditures were incurred, they were coded in such a manner that they could be accumulated in a promotional group, and, therefore, were identified directly with such group.

The indirect merchandising expenses were those not directly identifiable with any particular product group and represented the balance of the merchandising expenses of the pharmaceutical division. Because petitioner had determined that the indirect expenses were incurred for the benefit of all pharmaceutical products sold by it, those expenses were allocated on the basis of total sales of those particular product groups to total wholesaler sales.

iv. *Shipping Expenses*

Petitioner's total shipping expenses were derived from the consolidated expenses of petitioner's pharmaceutical division for the years 1971 through 1973. From the various distribution departments, data were obtained to determine the total number of shipments made and those shipments then were divided into the total cost of the shipping expenses to get a per unit cost of shipping. The resulting unit number then was applied to the number of units of Darvon and Darvon-N products shipped to determine the portion of shipping expenses allocable to Darvon and Darvon-N products.

H. *Technical Assistance Fees*

During the years 1971, 1972, and 1973, Lilly P.R. was billed for certain technical assistance that it received from petitioner. The amounts of technical assistance fees billed to Lilly P.R. by petitioner for each of those years were as follows:

Year	*Amount*
1971	$166,481
1972	129,054
1973	131,969

During the years 1965 through 1973, petitioner determined the technical assistance fees charged to Lilly P.R. by multiplying the number of hours of technical assistance reported by petitioner's employees by the technical assistance fee rates applicable to those employees. In addition, an amount equal to 5 percent of those hourly charges was added to each technical assistance invoice. The hourly technical assistance fee rates were equal to the average hourly compensation costs (including benefits and employment taxes) for petitioner's employees. One rate was used for all nonexempt employees, a second rate was used for all exempt employees below the level of director, and individual rates were used for employees at the director levels and above. Petitioner also billed Lilly P.R. for the travel expenses of petitioner's employees who traveled to Puerto Rico and for engineering services according to petitioner's standard rates.

The amounts billed by petitioner to Lilly P.R. during the years 1971 through 1973 represented all the technical assistance rendered by petitioner for the benefit of Lilly P.R. except for certain activities labeled as stewardship functions by petitioner. Petitioner's employees had no incentive to understate the amount of technical assistance fees chargeable to Lilly P.R. Indeed, the opposite was true because all amounts for technical assistance fees charged to Lilly P.R. reduced petitioner's department expenses for budgetary and profit performance purposes.

I. *Lilly P.R. Purchases From Petitioner*

1. *Raw Materials*

Lilly P.R.'s purchases of raw materials from third-party suppliers accounted for 80 percent, 81 percent, and 87 percent of its total raw material purchases in dollars for 1971, 1972, and 1973, respectively. The remainder of Lilly P.R.'s purchases of raw materials in those years were from petitioner.

Petitioner's prices for raw materials sold to Lilly P.R. were cost plus 100 percent for materials manufactured by petitioner and petitioner's cost for materials purchased by petitioner.

Petitioner's cost for both manufactured and purchased materials included its costs of packaging materials and material handling (e.g., freight in, freight to Puerto Rico, analytic assays on incoming materials, and warehousing).

2. Equipment and Machine Parts

As stated earlier in our findings of fact, Lilly P.R. purchased equipment and machine parts either directly from third-party suppliers or through petitioner during the years 1971 through 1973.

In cases in which Lilly P.R. purchased equipment directly from third-party suppliers, petitioner had no involvement whatsoever. In cases in which Lilly P.R. purchased equipment and machine parts through petitioner, Lilly P.R. was billed by petitioner for the requested items plus transportation and related services of petitioner (i.e., handling charges and costs of purchasing and engineering personnel) without any additional charges.

XIII. *Generic Propoxyphene Products*

A. *General*

In 1973, after the propoxyphene patent expired, at least 24 pharmaceutical manufacturers and/or distributors entered the United States market with generic propoxyphene hydrochloride products. The suggested prices to retail pharmacies for the generic propoxyphene hydrochloride products generally were about one-half of petitioner's net trade prices for the comparable Darvon products.

In February 1973, Lilly Research Laboratories began a program of evaluating generic propoxyphene hydrochloride products that were in direct competition with Darvon 65 mg. (PU 365) and Darvon Compound-65 (PU 369). The quality of the generic products was compared with that of petitioner's Darvon products by examining specifications such as (a) uniformity of drug content, (b) uniformity of weight, (c) decomposition of aspirin in compound products into acetic acid and salicylic acid, and (d) purity (i.e., presence of non-propoxyphene chemicals generated by the chemical manufacturing process). The results of that study indicated that petitioner's Darvon products were equal or superior to the

generic propoxyphene hydrochloride products. Two particular defects were found in the generic compound products. First, x-ray examination of generic products having a pellet formulation (i.e., containing an encased pellet of propoxyphene hydrochloride to prevent the interaction of propoxyphene hydrochloride and aspirin) showed that some of the lots of the generic products contained capsules that contained either no pellet or two pellets. Second, examination of generic products having an all-powder formulation (i.e., products in which the propoxyphene hydrochloride was mixed directly with the aspirin) showed greater disintegration of aspirin into acetic acid and free salicylic acid than in Darvon compound products.

Three of the pharmaceutical firms that entered the U.S market in 1973 with generic propoxyphene products were Zenith Laboratories, Inc., Rachelle Laboratories, Inc., and Smith Kline & French Laboratories. Each company sold both propoxyphene hydrochloride and a propoxyphene hydrochloride compound in 65 milligram strengths. We will discuss each company in turn below.

B. *Zenith Laboratories, Inc.*

Zenith Laboratories, Inc. (hereinafter Zenith) is a manufacturer of generic pharmaceuticals with facilities in northern New Jersey and the Virgin Islands. Its sales are divided evenly between private label manufacturing and sales under its own label, and are made both to large pharmaceutical companies and to drug distributors.

Zenith purchases rather than produces the basic chemical substances used in its products. Zenith's activities, then, are limited to the pharmaceutical manufacturing activities of formulation, encapsulation or tableting, and packaging. During the early 1970s, it had approximately 190 employees, including 3 employees assigned to work full-time in obtaining FDA approval for its products. Zenith does not promote its products directly to physicians.

Zenith's net sales for the years 1971, 1972, and 1973, respectively, were $9,436,000, $9,032,000, and $11,593,000. There is no evidence in the record indicating what proportion of its 1973 net sales were attributable to sales of generic propoxyphene hydrochloride products.

C. *Rachelle Laboratories, Inc.*

Rachelle Laboratories, Inc. (hereinafter Rachelle), is a subsidiary of International Rectifier Corp. located in Long Beach, California. Rachelle is largely a chemical company and produces basic substances as well as final pharmaceutical products. Rachelle produces products for sale not only to the human market, but to the veterinary market as well.

Rachelle chemically manufactures most of the substances used in the manufacture of its final pharmaceutical products. In 1973, Rachelle produced the propoxyphene hydrochloride used in its plain propoxyphene hydrochloride capsules;[38] it purchased, however, finished propoxyphene hydrochloride compound-65 capsules from the Caribe Chemical Co., Inc., of the Virgin Islands.

During 1973, Rachelle employed approximately 200 persons at its Long Beach facility. As of June 1973, 67 of those employees were involved in the chemical and pharmaceutical manufacture of products, and 29 were involved in the sale and marketing of Rachelle's products.

Rachelle's net sales were $5,944,000, $12,254,000, and $11,228,000 for 1971, 1972, and 1973, respectively. Rachelle's sales of propoxyphene hydrochloride products were approximately $50,000 in fiscal year ending June 30, 1973, and approximately $60,000 in fiscal year ending June 30, 1974.

D. *Smith Kline & French Laboratories*

Smith Kline & French Laboratories (hereinafter SKF) marketed a line of branded prescription pharmaceutical products on which patent protection had expired called the SK line. The SK line included a fairly wide range of antibiotics and mild tranquilizers as well as two propoxyphene hydrochloride products. SKF manufactured the plain propoxyphene hydrochloride product it marketed, but purchased its SK-65 Compound (a combination of propoxyphene hydrochloride and APC) from Milan Pharmaceuticals, Inc.

1. *Milan Pharmaceuticals, Inc.*

Milan Pharmaceuticals, Inc. (hereinafter Milan), of Morgantown, West Virginia, is a generic pharmaceutical manufactur-

[38] Rachelle purchased propiophenone and began its chemical manufacture of propoxyphene hydrochloride at the equivalent of petitioner's step 2.

ing firm similar to Zenith and Rachelle. Milan purchases the basic chemical substances used in its products, and has no chemical manufacturing facilities. Its sales, like those of Zenith, are made both under its own label and under those of the largest pharmaceutical houses. During the latter part of 1973, Milan employed approximately 235 persons, 4 of whom were involved in research and development and obtaining FDA approval for Milan's products.

Milan's net sales for the years 1971, 1972, and 1973 were $4,253,000, $7,826,000, and $10,818,000, respectively. Of the 1973 net sales amount, approximately $1,200,000 were attributable to sales of propoxyphene hydrochloride compound.

2. *SK-65 Compound*

The SK-65 Compound manufactured for SKF by Milan contained an encased pellet of propoxyphene hydrochloride to prevent the propoxyphene hydrochloride from interacting with and decomposing the aspirin in that product. Because SKF did not have the capability of inserting the propoxyphene hydrochloride pellets into the capsules of SK-65 Compound, SKF decided to purchase SK-65 Compound from Milan, which had already developed that capability. In addition, Milan had obtained FDA approval to manufacture the SK-65 Compound, and, therefore, the use by SKF of Milan as the source of SK-65 Compound was the most expeditious way for SKF to enter the propoxyphene hydrochloride market.

Milan's basic price to SKF in 1973 for SK-65 Compound was $14.50 per 1,000 filled capsules. Milan also charged SKF $0.15 per bottle for packaging the SK-65 Compound capsules in bottles of 100 capsules and $0.3 for packaging the SK-65 Compound capsules in bottles of 500 capsules. Thus, Milan's price to SKF for a bottle of 100 SK-65 Compound capsules was $1.60, and Milan's price to SKF for a bottle of 500 SK-65 Compound capsules was $7.55.

During 1973, SKF purchased 47,399,654 filled SK-65 Compound capsules from Milan at a total invoice cost of $742,865. Milan's sales to SKF of SK-65 Compound capsules in bottles of 100, bottles of 500, sample packages, and bulk during 1973 were as follows:

Type of package	*1973 Sales*
Bottle of 100 capsules	$295,072
Bottle of 500 capsules	346,689
Sample package of 4 capsules	34,094
Bulk	67,010
Total	742,865

SKF sold the SK-65 Compound products purchased from Milan to drug wholesalers in the United States. SKF's net trade price and price to wholesalers for bottles of 100 SK-65 Compound capsules were $3.75 and $3.09, respectively. SKF's net trade price and price to wholesalers for bottles of 500 SK-65 Compound capsules were $16.50 and $13.61, respectively.

SKF supplied to Milan at no charge the empty capsules, package inserts, labels, and bottle caps used by Milan in making SK-65 Compound for SKF. SKF's cost of providing those materials for Milan were $0.26 for a bottle of 500 SK-65 Compound capsules.

During 1973, Lilly P.R. manufactured the empty capsules it used to make Darvon Compound-65 and purchased from suppliers the package inserts, labels, and bottle caps for Darvon Compound-65.[39] During the period 1971 through 1973, petitioner sold billions of empty capsules to unrelated customers throughout the world. Petitioner's price per thousand for empty capsules of the type used by Lilly P.R. in manufacture of Darvon Compound-65 was about $1.60. During that period, Lilly P.R. lost, in the manufacturing process, approximately 3 percent of the empty capsules it used in the filling and finishing of Darvon Compound-65. Thus, the effective market price for empty capsules for Darvon Compound-65 was approximately $0.82 per bottle of 500 capsules. Lilly P.R.'s standard cost per bottle of 500 Darvon Compound-65 capsules for labels, package inserts, and bottle caps was approximately $0.04 in 1973.

Milan's credit terms to SKF in 1973 relative to Milan's sales of SK-65 Compound to SKF were a 1-percent discount for payment within 10 days and net for payment in 30 days.

SKF also purchased SK-65 Compound capsules from Milan for use as samples. Approximately 20 percent of the SK-65 Compound capsules used as samples by SKF in 1973 were

[39] Lilly P.R. purchased from petitioner all labels and literature, as well as some bottle caps, used in its packaging of Darvon and Darvon-N products.

packaged by Milan in packages of four capsules. Milan's price to SKF for such a sample package was $0.135 per package. The remaining SK-65 Compound capsules purchased by SKF from Milan for use as samples were purchased in bulk at the basic price of $14.50 per thousand capsules and packages by SKF.

SKF loaned to Milan, at no charge, equipment used by Milan in 1973 to package SK-65 Compound capsules in sample packages. That equipment was excess old equipment owned by SKF which was not being used by it at the time the equipment was made available to Milan.

Milan had its own quality control personnel who performed all required FDA checks on products it produced. SKF, however, performed complete quality control analysis on the first several commercial batches of SK-65 Compound it purchased from Milan. After that time, SKF accepted Milan's quality control assay reports, but continued to perform a physical quality control check upon receipt of the SK-65 capsules. SKF also retained from each lot of SK-65 Compound capsules purchased from Milan a sampling of capsules for stability testing. In addition, during each of the production runs of SK-65 Compound at Milan, SKF had from 1 to 3 of its own quality control personnel at Milan's plant to observe the production process. SKF's quality control personnel were present at Milan's plant for the duration of each production run which, depending on the size of the run, was approximately 1 week.

SKF paid the freight costs related to shipments of SK-65 Compound from Milan to SKF in 1973. SKF did not maintain any FDA required records for Milan; Milan maintained all the required records relative to its production of SK-65 Compound. SKF did not make any patent or manufacturing know-how relative to SK-65 Compound available to Milan. SKF did not perform any research and development, pilot plant testing, or process development testing for Milan.

XIV. *Respondent's Proposed Adjustments*

A. *Notice of Deficiency*

In his notice of deficiency dated March 26, 1976, respondent allocated gross income from Lilly P.R. to petitioner under section 482 in the amounts of $18,522,924, $17,820,986, and $10,717,187 for 1971, 1972, and 1973, respectively, with respect

to Lilly P.R.'s sales of Darvon and Darvon-N products to petitioner in those years.

The allocations of income in the notice of deficiency were based upon a multi-step method of determining Lilly P.R.'s gross income on sales of Darvon and Darvon-N products to petitioner. Under that method, Lilly P.R.'s gross income on sales to petitioner of Darvon and Darvon-N products was equal to the sum of the following amounts:

(a) Lilly P.R.'s cost of goods sold;

(b) Lilly P.R.'s location savings (i.e., the cost savings resulting from operating in Puerto Rico rather than in the continental United States);

(c) a gross profit for the Mayaguez facility of Lilly P.R. determined by respondent; and

(d) a gross profit for the Carolina facility of Lilly P.R. determined by respondent.

The location savings of the Mayaguez and Carolina facilities of Lilly P.R. for the years 1971, 1972, and 1973 were as follows:

	1971	*1972*	*1973*
Mayaguez	$1,464,359	$1,354,798	$1,211,242
Carolina	3,263,957	3,910,644	2,602,491
Total	4,728,316	5,265,442	3,813,733

In the notice of deficiency, respondent determined the gross profit for Lilly's P.R.'s Mayaguez facility by constructing prices for the bulk propoxyphene hydrochloride and propoxyphene napsylate transferred by the Mayaguez facility to Lilly P.R.'s Carolina facility. Respondent determined that those prices were $88, $86, and $77 per kilogram for 1971, 1972, and 1973, respectively. The gross profit of the Mayaguez facility as determined by respondent was the excess of those prices over Lilly P.R.'s cost of manufacturing propoxyphene hydrochloride and propoxyphene napsylate.

In the notice of deficiency, respondent determined that the gross profit of the Carolina facility was 25 percent of the sum of (a) the Carolina facility's "cost" of acquiring the propoxyphene hydrochloride and propoxyphene napsylate from the Mayaguez facility at the transfer prices constructed by respondent, (b) the manufacturing cost of the Carolina facility (exclusive of the actual cost of propoxyphene hydrochloride

and propoxyphene napsylate), and (c) the location savings attributable to the Carolina facility.

B. *Amendment to Answer*

In an amendment to answer filed April 14, 1981, respondent increased the section 482 allocation of gross income from Lilly P.R. to petitioner with respect to Darvon and Darvon-N products by $23,952,413 for the period 1971 through 1973, as indicated by the following table:

	Sec. 482 allocation		
	Amendment to answer	*Notice of deficiency*	*Increase in allocation*
1971	$26,620,387	$18,522,924	$8,097,463
1972	26,314,918	17,820,986	8,493,932
1973	18,078,205	10,717,187	7,361,018
Total	71,013,510	47,061,097	23,952,413

The increase in section 482 allocations in the amendment to answer resulted from a new method of computing Lilly P.R.'s gross income from sales of Darvon and Darvon-N products to petitioner. In the amendment to answer, respondent asserted that such gross income should be limited to 130 percent of the sum of Lilly P.R.'s manufacturing costs and location savings. The notice of deficiency pricing method was asserted by respondent as an alternative position to the amendment to answer pricing method.

OPINION

Introduction

The issues before this Court involve respondent's reallocations of gross income from Lilly P.R. to petitioner for the taxable years 1971, 1972, and 1973.

Petitioner is engaged in the manufacture and sale of pharmaceutical products. Petitioner invented and patented propoxyphene hydrochloride (Darvon) during the early 1950s and propoxyphene napsylate (Darvon-N) during the early 1960s. Darvon was first introduced into the U.S. market in 1957, and was manufactured by petitioner in Indiana from 1957 through 1966. Darvon-N was not introduced into the U.S. market until 1971 and was never manufactured by petitioner.

During 1965, petitioner organized Lilly P.R. as a wholly owned Puerto Rican subsidiary. In December 1966, petitioner transferred "all right, title and interest in and to" the propoxyphene and napsylate patents to Lilly P.R., as well as the exclusive right to use petitioner's manufacturing know-how. The transaction qualified for nonrecognition under section 351 and, therefore, Lilly P.R. reported no gain or loss on the transaction in 1966. After the transfer in 1966 and throughout the years in issue, Lilly P.R. was the sole manufacturer of Darvon and Darvon-N; Lilly P.R. sold its products to petitioner, who in turn marketed the products throughout the United States.

In the statutory notice of deficiency and in the amended answer, respondent, through adjustments in intercorporate pricing, reallocated the income attributable to the propoxyphene and napsylate patents and related manufacturing know-how from Lilly P.R. to petitioner under the authority of section 482. Respondent's methods of determining the section 482 allocations in the notice of deficiency, the amended answer, and at trial treat Lilly P.R. as a contract manufacturer and do not take into account Lilly P.R.'s ownership of the manufacturing intangibles.

The first issue we must decide is whether Lilly P.R. should be considered the owner of the propoxyphene and napsylate patents and manufacturing know-how for purposes of determining arm's-length prices to petitioner under section 482. We must then determine whether respondent's section 482 adjustments were arbitrary, capricious, or unreasonable. Finally, we must make a determination of arm's-length prices between petitioner and Lilly P.R.

Issue 1. Ownership of Intangibles for Section 482 Purposes

The first issue for decision is whether, for purposes of determining arm's-length prices under section 482,[40] the

[40] Sec. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

income attributable to the manufacturing intangibles should be allocated to petitioner or Lilly P.R.

Petitioner contends that it transferred complete ownership of the propoxyphene and napsylate patents and manufacturing know-how to Lilly P.R., and that, therefore, the income from such patents and know-how belongs to Lilly P.R. Although respondent concedes that Lilly P.R. acquired legal title to the patents and know-how in 1966 in a valid section 351 transfer,[41] he maintains that for purposes of section 482, legal ownership of the intangibles can be disregarded and all income attributable to them reallocated from Lilly P.R. to petitioner. During all relevant years, Lilly P.R. was a qualifying section 931 possessions corporation and was exempt from U.S. tax on the income earned from its manufacture and sale of Darvon and Darvon-N products.

A. *Background of Relevant Provisions*

1. *Tax Incentives for Companies Operating in Puerto Rico*

a. *Section 931*

Section 931, in effect during the years in issue, provided in relevant part:

SEC. 931. INCOME FROM SOURCES WITHIN POSSESSIONS OF THE UNITED STATES.

(a) General Rule.—In the case of citizens of the United States or domestic corporations, gross income means only gross income from sources within the United States if the conditions of both paragraph (1) and paragraph (2) are satisfied:

(1) 3-YEAR PERIOD.—If 80 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of this section) for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States; and

(2) TRADE OR BUSINESS.—If—

(A) in the case of such corporation, 50 percent or more of its gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States.

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[41] SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) GENERAL RULE.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

Section 931 had its genesis 64 years ago in section 262 of the Revenue Act of 1921, ch. 136, 42 Stat. 271, which first exempted from Federal taxes the incomes of U.S. corporations operating in a possession.[42] Section 262(c) provided the requirements for qualification as a possessions corporation later set forth in section 931. The section was reenacted without any material change by section 251 of the Revenue Act of 1928, ch. 852, 45 Stat. 850, and section 931 of the Internal Revenue Code of 1954. It was not until enactment of the Tax Reform Act of 1976, that any material changes were made in the basic tax exemption for possessions corporations, and then Congress substituted an equally favorable tax credit mechanism. See section 936, Tax Reform Act of 1976, Pub. L. 94–455, 90 Stat. 1643.

The congressional intent for section 931 and its predecessors consistently has been the encouragement of American business investments in possessions of the United States. American companies operating in the possessions originally were subjected to double taxation by the imposition of both the Federal corporate income tax and the taxes levied by the possessions governments. Section II of the Tariff Act of 1913, ch. 16, 38 Stat. 166; Revenue Act of 1918, ch. 18, 40 Stat. 1058. Congress perceived that the tax burden so created placed American businesses at a competitive disadvantage when compared with their British and French counterparts, which were not subject to taxation on the profits earned abroad unless they were paid back to the home company. Congress consequently enacted section 931 and its predecessors to remove that competitive disadvantage and to encourage American business activity in the U.S. possessions. H. Rept. 350, 67th Cong., 1st Sess. 1 (1921), 1939–1 C.B. (Part 2) 168, 174.

Generally, section 931 provided corporations an exclusion of possession source income if they met the 80-percent source test and 50-percent active trade or business test. Because of that exclusion, and because dividends received by a domestic corporation from its wholly owned possessions subsidiary were not eligible for the intercorporate dividends received deduction of section 246(a)(2)(B), possessions corporations amassed

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[42] For an overview of the tax relationship between the United States and its possessions and territories, see Hoff, "U.S. Federal Tax Policy Towards the Territories: Past, Present and Future," 37 Tax L. Rev. 53 (1981).

large amounts of income which were not repatriated to the United States. To encourage investment of possessions source earnings in the United States, in 1976 Congress enacted new section 936. That section eliminated the tax exemption for income from foreign investments outside the possessions and permitted the intercorporate dividends received deduction for dividends received from a wholly owned possessions subsidiary. Section 936 essentially transformed the exemption mechanism contained in section 931 to a credit system whereby the U.S. parent can elect a special tax credit to offset the U.S. tax on its wholly owned possessions subsidiary's source income.[43]

It is clear from the legislative record that Congress was aware of the highly favorable tax benefits afforded U.S. corporations operating in Puerto Rico. It is equally clear that Congress intended to retain and reaffirm such tax benefits, at least on the part of the United States, by its enactment of section 936. As the Senate Finance Committee and the House of Representatives Committee on Ways and Means stated, in virtually identical reports:

> The special exemption provided (under sec. 931) in conjunction with investment incentive programs established by possessions of the United States, especially the Commonwealth of Puerto Rico, have been used as an inducement to U.S. corporate investment in active trades and businesses in Puerto Rico and the possessions. Under these investment programs little or no tax is paid to the possessions for a period as long as 10 to 15 years and no tax is paid to the United States as long as no dividends are paid to the parent corporation.
>
> *Because no current U.S. tax is imposed on the earnings if they are not repatriated, the amount of income which accumulates over the years from these business activities can be substantial.*The amounts which may be allowed to accumulate are often beyond what can be profitably invested within the possession where the business is conducted. As a result, corporations generally invest this income in other possessions or in foreign countries either directly or through possessions banks or other financial institutions. In this way possessions corporations not only avoid U.S. tax on their earnings from businesses conducted in a possession, but also avoid U.S. tax on the income obtained from reinvesting their business earnings abroad.

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[43]Sec. 936 allows the tax credit to domestic corporations operating in Puerto Rico and all possessions of the United States except the Virgin Islands. Sec. 931 was retained to provide the possessions source income exclusion to qualifying U.S. individual citizens. For sec. 931 purposes, however, "possession" does not include Puerto Rico, Guam, or the Virgin Islands. Sec. 931(c); sec. 1.931-1(a), Income Tax Regs. The Puerto Rican-source income exclusion for qualifying U.S. individual citizens is now contained in sec. 933.

The committee after studying the problem concluded that it is inappropriate to disturb the existing relationship between the possessions investment incentives and the U.S. tax laws because of the important role it is believed they play in keeping investment in the possessions competitive with investment in neighboring countries. The U.S. Government imposes upon the possessions various requirements, such as minimum wage requirements and requirements to use U.S. flagships in transporting goods between the United States and various possessions, which substantially increase the labor, transportation and other costs of establishing business operations in Puerto Rico. Thus, without significant local tax incentives that are not nullified by U.S. taxes, the possessions would find it quite difficult to attract investments by U.S. corporations.

[S. Rept. 94-938 (1976), 1976-3 C.B. (Vol. 3) 315, 315-316; H. Rept. 94-658 (1975), 1976-3 C.B. (Vol. 2) 945, 946-947. Emphasis added and fn. refs. omitted.][14]

(The excerpt quoted is from the Senate report; the House report version differs by two words.)

b. *Puerto Rico's Operation Bootstrap*

In 1948, as part of its Operation Bootstrap, the Commonwealth of Puerto Rico matched the U.S. tax exemption for possessions corporations. Industrial Tax Exemption Act of 1948, P.R. Laws Ann. tit. 13, secs. 221-238 (1955). In addition to exempting corporations from Puerto Rican corporate income taxes, the legislation also provided exemptions from certain property taxes, excise taxes, and license fees, with a gradual phase-out of exemptions by 1962. The tax exemptions generally were available for a corporation manufacturing items not produced on a commercial scale in Puerto Rico prior to 1947.

In 1954, the 1948 Act was reenacted with an amendment providing for an additional 10-year exemption for new businesses subsequently locating on the island. Industrial Incentive Act of 1954, P.R. Laws Ann. tit. 13, secs. 241—251 (1977). Later, as the 1950s drew to a close and some of the original investors approached the end of their exemption periods, pressure mounted for further extensions of, and

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[14] On Sept. 3, 1982, Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, 96 Stat. 324. TEFRA contains new provisions dealing specifically with the issue before us involving the tax-free transfer of intangibles to a possessions corporation. However, no inference can be drawn from those provisions and the fact of their enactment can have no effect on our decision herein. See H. Rept. 97-760 (Conf.) (1982), 1982-2 C.B. 600, 617 n. 1. Moreover, the provisions are effective, with two exceptions not relevant herein, only for taxable years beginning after Dec. 31, 1982.

liberalizations in the industrial incentives. The Industrial Incentive Act of 1963, P.R. Laws Ann. tit. 13, secs. 252–252j (1977), as subsequently enacted, provided completely new exemption grants for periods ranging from 10 to 25 years and retained virtually all the provisions of the 1954 Act.

2. *Nonrecognition Provision of Section 351*

Section 351 provides for the nonrecognition of gain or loss upon the transfer of property to a corporation if immediately after the transfer the corporation is controlled[45] by the transferor. The transfer of property must be "solely in exchange for stock or securities" of the transferee corporation. The transfer of property to an existing controlled corporation will qualify the transaction for nonrecognition treatment even though the transferor did not receive any additional stock at the time of the transfer.[46]

Petitioner transferred the propoxyphene and napsylate patents and manufacturing know-how to Lilly P.R., a wholly owned subsidiary.[47] It is undisputed that petitioner's transfer of the patents and know-how to Lilly P.R. qualified for nonrecognition under section 351. Respondent not only has issued a private ruling letter (as set out in pp. 1029–1031 of our findings of fact) to petitioner in which he ruled that no gain or

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[45] "Control" is defined by sec. 368(c) as being "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." There is no question of control being present in the case as Lilly P.R. was at all times the wholly owned subsidiary of petitioner. We mention control merely as being one of the requirements for nonrecognition under sec. 351.

[46] Rev. Rul. 64–155, 1964–1 C.B. (Part 1) 138 provides, in pertinent part:

"X, a domestic corporation, proposes to contribute appreciated property to Y, an existing wholly owned foreign subsidiary. Although X will not receive any additional Y shares, the transaction will be considered an exchange of property for stock described in section 351 of the Internal Revenue Code of 1954."

Revenue rulings "have none of the force or effect of Treasury decisions" and do not commit the Service to a particular interpretation of the law. *Helvering v. New York Trust Co.*, 292 U.S. 455 (1934). While a ruling is not controlling, however, it is not without weight and we will consider it as a statement of respondent's position on a given set of facts. *Groves v. United States*, 533 F.2d 1376 (5th Cir. 1976), affg. an unreported District Court opinion, cert. denied 429 U.S. 1000 (1976).

[47] Petitioner's transfer of patents and know-how was a "transfer of property." See, e.g., *Hooker Chemicals & Plastic Corp. v. United States*, 591 F.2d 652 (Ct. Cl. 1979); *DuPont de Nemours & Co. v. United States*, 471 F.2d 1211 (Ct. Cl. 1973); *Bell International Corp. v. United States*, 381 F.2d 1004 (Ct. Cl. 1967); Rev. Rul. 71–564, 1971–2 C.B. 179; Rev. Rul. 64–56, 1964–1 C.B. (Part I) 133. See also generally Beschell, Taxation of Patents, Trademarks, Copyrights & Know-How, par. 6.3, 6.3A, at 6–5—6–14 (1974).

loss on the transfer would be recognized under section 351,[48] but has emphasized through counsel on brief that he does not challenge the validity of the section 351 transfer. Thus, petitioner recognized no gain or loss upon its transfer of patents and know-how to Lilly P.R. in 1966 and, after such transfer, Lilly P.R. was the legal owner of those patents and know-how.

B. *Interrelationship of Section 482 and Sections 351 and 931*

1. *Introduction*

a. *History and Purpose of Section 482*

Section 482 had its origin in Regulation 41, Articles 77 and 78 of the War Revenue Act of 1917, ch. 63, 40 Stat. 300, which gave the Commissioner the authority to require related corporations to file consolidated returns "Whenever necessary to more equitably determine the invested capital or taxable income." It reappeared in section 240(d) of the Revenue Act of 1921, ch. 136, 42 Stat. 260, as part of the provisions liberalizing the consolidated return rules.[49] Section 240(d) permitted the Commissioner to consolidate the accounts of affiliated corporations "for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or business." Section 240(d) of the Revenue Act of 1921 was successively reenacted as section 240(d) of the Revenue Act of 1924, ch. 234, 43 Stat. 288, and as section 240(f) of the Revenue Act of 1926, ch. 27, 44 Stat. 46, both of which permitted taxpayers to request the Commissioner to consolidate the accounts of related businesses.

Section 45 of the Revenue Act of 1928, ch. 852, 45 Stat. 806, gave the predecessor of section 482 independent status by

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[48] A ruling may be modified or revoked by the Service, effective in rare cases even retroactively. Sec. 7805(b); sec. 601.201(1), Statement of Procedural Rules; *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, 184 (1957). The record in this case clearly indicates that the representations of fact by petitioner upon which the Service's ruling to petitioner was based were accurate. The ruling issued to petitioner has not been revoked and thus is controlling. See *Wisconsin Nipple & Fabricating Corp. v. Commissioner*, 67 T.C. 490, 497 (1976), affd. 581 F.2d 1235 (1978).

[49] Sec. 240 allowed affiliated corporations, which were previously required to file consolidated returns, to file separate returns. Corporations entitled to the benefits of sec. 262 (the predecessor of sec. 931), however, were treated as foreign corporations by sec. 240(d) and thus were prevented from filing consolidated returns. Sec. 1504 (b)(4), I.R.C. 1954, continues the possessions corporation proscription from filing consolidated returns.

eliminating the taxpayer's power to invoke the section and emancipating it from the consolidated return provisions. The language in the new section 45 was essentially the same as that contained in the present section 482. The legislative history of the provision indicated that:

> Section 45 is based upon section 240(f) of the 1926 Act, broadened considerably in order to afford adequate protection to the Government made necessary by the elimination of the consolidated return provisions of the 1926 Act. The section of the new bill provides that the Commissioner may, in the case of two or more trades or businesses owned or controlled by the same interests, apportion, allocate, or distribute the income or deductions between or among them, as may be necessary in order to prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of "milking"), and in order clearly to reflect their true tax liability. [H. Rept. 2, 70th Cong., 1st Sess. (1927), 1939–1 C.B. (Part 2) 395; see also S. Rept. 960, 70th Cong., 1st Sess. (1928), 1939–1 C.B. (Part 2) 426.]

b. *Scope of Respondent's Authority*

Section 482 gives respondent broad authority to allocate between or among commonly controlled[50] corporations their respective gross incomes, deductions, credits, or allowances when necessary either to prevent the evasion of taxes or in order clearly to reflect the income of such corporations.[51] We emphasize that these are alternate bases for application of the section.

A section 482 allocation based upon tax avoidance grounds is primarily intended to prevent the artificial shifting or milking of profits.[52] Thus, respondent's application of section 482 has been upheld when the challenged transaction was arranged by the related parties without a valid business purpose and solely in order to avoid taxes. E.g., *Asiatic Petroleum Co. v. Commissioner*, 79 F.2d 234 (2d Cir. 1935), affg. 31 B.T.A. 1152 (1935),

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[50] The term "controlled," as defined by sec. 1.482–1(a)(3), Income Tax Regs., has a much more expansive meaning than that used in secs. 351 and 368. See n. 44 *supra*. For the purposes of sec. 482, " 'controlled' includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised." Lilly P.R. was at all times the wholly owned subsidiary of, and was controlled by, petitioner.

[51] See generally B Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, par. 15.06, at 15–16 (4th ed. 1979); Eustice, "Tax Problems Arising From Transactions Between Affiliated or Controlled Corporations," 23 Tax L. Rev. 451, 460–462, 480–496 (1968).

[52] For purposes of sec. 482, the terms "tax evasion" and "tax avoidance" are interchangeable. See *Asiatic Petroleum Co. v. Commissioner*, 79 F. 2d 234, 236 (2d Cir. 1935); *Foster v. Commissioner*, 80 T.C. 34, 158 (1983), affd. on this issue 756 F. 2d 1430 (9th Cir. 1985).

cert. denied 296 U.S. 645, rehearing denied 296 U.S. 664 (1935); *Northwestern National Bank of Minneapolis v. United States*, an unreported case (D. Minn. 1976, 38 AFTR 2d 76-1400, 76-1 USTC par. 9408), affd. 556 F.2d 889 (8th Cir. 1977).

Respondent also may compel a reallocation of income under section 482 where the incomes of related parties are not clearly reflected, even in the absence of tax avoidance motives. This aspect of the section is concerned with properly allocating income to the person who earns the income and the deduction to the person who, in substance, incurred the expenses and obtained the benefits of the correlative deduction. Accordingly, the clear reflection of income doctrine has justified an allocation when the challenged transaction shifted income earned by one party to a related party (*Baldwin-Lima-Hamilton Corp. v. United States*, 435 F.2d 182 (7th Cir. 1970), affg. in part and revg. and remanding in part an unreported District Court decision), or when it resulted in an artificial mismatching of a party's income and expenses. *Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962), affg. 189 F. Supp. 733 (N.D. Cal. 1960); *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (2d Cir. 1952), revg. and remanding on this issue 16 T.C. 882 (1951), cert. denied 344 U.S. 874 (1952).

2. *Income From Manufacturing Intangibles*

a. *Section 482 Allocations Involving Nonrecognition Transfers*

The issue now before us is whether Lilly P.R. should be considered the owner of the propoxyphene and napsylate patents and manufacturing know-how for purposes of determining arm's-length prices to petitioner for Lilly P.R.'s Darvon and Darvon-N products.[53] Respondent concedes the validity of petitioner's section 351 transfer of the manufacturing intangibles to Lilly P.R. and that Lilly P.R. is the legal owner of the intangibles. Respondent alleges, however, that he has the authority under section 482 to disregard the legal owner-

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[53] Sec. 1.482-1(b)(1), Income Tax Regs., adopted in 1968, provides, in pertinent part:

(b) *Scope and purpose.* (1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. * * * The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

ship of the intangibles and to reallocate the income attributable to the intangibles from Lilly P.R. back to petitioner in order to prevent the evasion of taxes or clearly to reflect petitioner's income.

Petitioner agrees that respondent may use section 482 to reallocate income from property received in a section 351 transfer back to the transferor. Petitioner contends, however, that allocations ignoring nonrecognition transfers are upheld by the courts in only two narrow factual situations, discussed hereinafter, neither of which applies in this case. Therefore, petitioner asserts that respondent has no authority to disregard completely petitioner's 1966 transfer of the manufacturing intangibles to Lilly P.R. by reallocating the income attributable to those intangibles to petitioner. For the reasons discussed below, we agree with petitioner.

As we stated earlier, section 482 provides that respondent may make allocations between related parties when necessary either to prevent the evasion of taxes, or in order clearly to reflect their incomes. Moreover, section 1.482–1(d)(5), Income Tax Regs., specifically provides:

> Section 482 may, when necessary to prevent the avoidance of taxes or to clearly reflect income, be applied in circumstances described in sections of the Code (such as section 351) providing for nonrecognition of gain or loss. See, for example, *National Securities Corporation v. Commissioner of Internal Revenue*, 137 F. 2d 600 (3rd Cir. 1943), cert. denied 320 U.S. 794 (1943).

National Securities Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943), affg. 46 B.T.A. 562 (1942), and its progeny delineate the situations in which courts have upheld section 482 allocations that, in effect, ignored nonrecognition transfers. Those situations can be separated into two narrowly defined categories: (1) Cases in which property was transferred in a nonrecognition transaction and subsequently disposed of by the transferee, and in which the sole purpose of the transfer was to achieve tax consequences on the disposition of the property by the transferee that were more favorable than the tax consequences of a disposition by the transferor (see, e.g., *National Securities Corp. v. Commissioner, supra*; *Southern Bancorporation v. Commissioner*, 67 T.C. 1022 (1977); *Northwestern National Bank of Minneapolis v. United States*, an unreported case (D. Minn. 1976, 38 AFTR 2d 76–1400, 76–1 USTC par.

9408), affd. 556 F.2d 889 (8th Cir. 1977));[54] and (2) cases in which the nonrecognition transfer of property resulted in an artificial separation of income from the expenses of earning the income. See, e.g., *Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962); *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (2d Cir. 1952). But see *Heaton v. United States*, 573 F. Supp. 12 (E.D. Wash. 1983); *Fanning v. United States*, 568 F. Supp. 823 (E.D. Wash. 1983). The leading cases in each category are discussed in detail below.

(i) *National Securities Corp. and Avoidance of Taxes*

The leading case in the first category is *National Securities Corp. v. Commissioner*, *supra*. In that case, a parent corporation transferred shares of stock in an unrelated corporation, Standard Gas & Electric Co. (Standard), to the taxpayer, its wholly owned subsidiary, in exchange for additional shares of the taxpayer's stock. The transaction qualified as a nonrecognition exchange under the predecessor of section 351.[55] The parent's basis in the Standard stock was approximately $140,000, but the stock had only a market value of approximately $8,500 at the time of the transfer. At the end of the transfer year, the taxpayer sold the stock for $7,175 and reported on its return a loss of $133,202, the difference between the parent's basis in the stock (the taxpayer's carryover basis under section 362) and the amount realized by the taxpayer. The parent, having already realized a net capital loss for that year in excess of the amount deductible under the relevant revenue provision, could not have derived any tax benefit from the loss on the sale if it had retained and then sold the Standard stock itself.

Acting pursuant to section 482, the Commissioner disregarded the nonrecognition transfer of stock and allocated the entire loss on the sale from the taxpayer to the parent.[56] The taxpayer contended that the nonrecognition and basis provisions of sections 351 and 362, respectively, precluded the application of section 482 to the taxpayer. The Court of

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[54] But see *Ruddick Corp. v. United States*, 226 Ct. Cl. 426, 643 F.2d 747 (1981), remanded 3 Cl. Ct. 61 (1983), affd. 732 F.2d 168 (Fed. Cir. 1984).

[55] To facilitate our discussion of the cases, we will hereafter refer to the sections involved solely by their current designations.

[56] At trial, the Commissioner conceded that the taxpayer was entitled to deduct the portion of loss sustained during the period in which it held the stock.

Appeals for the Third Circuit upheld the Commissioner's allocation from the taxpayer to the parent under section 482 of the deduction for the portion of the loss sustained before the transfer.

The Court of Appeals based its holding in *National Securities Corp.* upon the clear reflection of income standard rather than the tax avoidance test of section 482. Factually, however, the case involved a tax avoidance situation in which a nonrecognition transaction was used solely to shift to the taxpayer the tax consequences of a preconceived disposition of stock in order to obtain a tax benefit that could not be obtained by the parent. Because there was no valid business purpose for the transfer, we view *National Securities Corp.* and all members of the first category primarily as tax avoidance cases. See *Southern Bancorporation v. Commissioner*, 67 T.C. 1022, 1027 (1977).

The facts of the case before us are readily distinguishable from those discussed above. Petitioner's transfer of the patents and manufacturing know-how to Lilly P.R. was motivated by bona fide business reasons, and Lilly P.R. did not thereafter dispose of the transferred assets. Petitioner in 1965 needed to expand its chemical and pharmaceutical manufacturing facilities in order to meet the projected 1975 U.S. requirements for its products. After considering several alternatives, petitioner decided to locate two such facilities in Puerto Rico. That decision allowed petitioner to take advantage of the congressionally sanctioned tax incentives, Puerto Rican tax exemptions, and lower labor costs available in Puerto Rico. In addition, petitioner was able to diversify geographically its manufacturing facilities.

Once petitioner determined that the products it would manufacture in Puerto Rico were Darvon and Darvon-N, it consulted with its tax counsel to ascertain the most desirable means of doing so. Petitioner was advised that it could minimize its Federal income taxes by transferring ownership of the patents and the manufacturing intangibles relating to the production of Darvon and Darvon-N to a subsidiary possessions corporation that qualified for the benefits of section 931. On the basis of that advice, petitioner organized Lilly P.R. to operate the manufacturing facilities and executed the Assignment of Patent and Related Technical Data.

It is well established that taking advantage of tax benefits made available by Congress does not constitute tax avoidance. In *Barber-Green Americas, Inc. v. Commissioner*, 35 T.C. 365 (1960), this Court held that the organization of a subsidiary to take advantage of the Western Hemisphere Trade Corporation provisions of sections 921 and 922, and the organization of the business and sales procedures of the subsidiary to qualify for the benefits of sections 921 and 922, did not constitute tax avoidance under the predecessor of section 269. See also *Baldwin-Lima-Hamilton Corp. v. United States*, 435 F.2d 182 (7th Cir. 1970). Sections 921 and 922 provided a special deduction for corporations making sales in the Western Hemisphere. The purpose of the tax incentives provided in those sections is similar to the purpose of section 931, namely, to promote commerce and economic development in the targeted areas.

What we stated in *Barber-Greene* is equally applicable here:

> When the Congress offered certain tax benefits as an inducement to United States corporations to engage in foreign trade, it was to be expected that some corporations would seek to avail themselves of these benefits. The creation of a subsidiary to carry on the business in the Western Hemisphere area of an existing domestic corporation does not constitute tax avoidance within the meaning of [the predecessor of section 269], * * * and there seems to be no good reason why the deliberate organizing of such a corporation's business and sales procedures to meet the other conditions specified by the legislation and thereby to qualify for the tax benefits offered should be regarded as tax avoidance. Otherwise the purpose of organizing a subsidiary would be lost and the congressional objective would not be carried out.
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> It has repeatedly been stated that taxpayers have the right so to arrange their affairs that their taxes shall be as low as possible, *Gregory v. Helvering*, 293 U.S. 465 (1935); that one is not obliged to pursue a course of action giving rise to a greater tax liability if another is open which will give rise to a lesser liability, *Fruit Belt Telephone Co.*, 22 B.T.A. 440 (1931), * * * and that what a taxpayer did, rather than what he might have done, determines his liability. *Seminole Flavor Co.*, 4 T.C. 1215, 1230 (1945). * * *
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> [35 T.C. at 386.]

See also *Achiro v. Commissioner*, 77 T.C. 881 (1981); Rev. Rul. 76–363, 1976–2 C.B. 90; Rev. Rul. 70–238, 1970–1 C.B. 61.

In enacting section 931, Congress intended to encourage American business investments in U.S. possessions. Responding to that congressional invitation, petitioner organized Lilly P.R. as a wholly owned Puerto Rican subsidiary qualifying for the tax benefits of section 931. Such action was motivated by

valid business purposes and does not constitute tax avoidance.[57] Accordingly, *National Securities Corp. v. Commissioner, supra*, and the tax avoidance standard of section 482 are inapplicable.

ii. *Central Cuba Sugar, Rooney, and Clear Reflection of Income*

Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir. 1952), and *Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962), are typical of the second category of cases noted earlier, i.e., cases in which nonrecognition transfers or property resulted in artificial separations of income from the expenses of earning that income. In each of those cases, the taxpayer transferred a planted crop, together with other assets, to a newly formed corporation in exchange for all the stock of the corporation.[58] The crop was harvested and the profit from the sale of the crop was reported as income by the new corporation. The taxpayer deducted the expenses incurred in growing the crop prior to its transfer and as a result, sustained a net operating loss which it sought to carry back to prior years. In each case, the Court of Appeals upheld the Commissioner's allocation of all the expenses of raising the crop from the taxpayer to the transferee corporation.

In *Central Cuba Sugar*, the Court of Appeals for the Second Circuit rejected the taxpayer's argument that section 482 was inapplicable in the face of the nonrecognition reorganization provisions. It observed that section 482 had its origin in the consolidated returns provisions, and that consolidation would have shown the income which accrued during the year for the business as a whole. It stated that allocation likewise should be available to dissolve the fiction that one entity was unprofit-

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[57] Because of the lack of tax avoidance motives herein, petitioner states that *Ruddick Corp v. United States*, 226 Ct. Cl. 426, 643 F.2d 747 (1981), remanded 3 Cl. Ct. 61 (1983), affd. 732 F.2d 168 (Fed. Cir. 1984), is controlling. In that case, the Court of Claims held that, absent the taint of tax avoidance or tax evasion, the Commissioner is not authorized by sec. 482 to allocate income on the ground of clear reflection of income in a situation involving a specific nonrecognition provision. However, *National Securities* and subsequent law make it clear that a valid business purpose will not preclude the application of sec. 482 in such a situation when necessary clearly to reflect income. Secs. 1.482–1(c), 1.482–1(d)(5), Income Tax Regs.; *Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962); *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (2d Cir. 1952).

[58] *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (2d Cir. 1952), revg. and remanding this issue 16 T.C. 882 (1951), involved a tax-free reorganization under the predecessor of sec. 368(a)(1)(F); the taxpayers in *Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962), affg. 189 F. Supp. 733 (N.D. Cal. 1960), transferred their crop under sec. 351.

able, and that "to achieve 'the rough matching of expenses and income previously attained,' allocation of the expenses to the concern which is to profit by them is the alternative." 198 F.2d at 216; citations omitted. The Ninth Circuit Court of Appeals in *Rooney* followed suit, concluding that "section 482 * * * will control when it conflicts with section 351 * * * as long as the discretion of the Commissioner in reallocating is not abused." 305 F.2d at 686. Citing *Central Cuba Sugar*, the Court held that there was no abuse of discretion by the Commissioner.

Both *Central Cuba Sugar* and *Rooney* dealt with bifurcations of a single taxable year. Both cases involved nonrecognition transfers of unharvested crops to new corporations, with the transferee corporations reporting the crop income and the transferors deducting the crop growing expenses and, consequently, suffering net operating losses.[59] Both cases also involved transfers which the Courts acknowledged were motivated by valid business reasons.[60] Also, in both it was the subsequent dispositions of the transferred crops by the successor corporations that triggered the application of section 482. In *Central Cuba Sugar* and *Rooney* the Courts focused on the timing of the transfers, which, coupled with the taxpayers' methods of accounting for growing crops, bifurcated the taxpayers' taxable years and artificially separated the expenses and the income attributable thereto. The Courts in both cases approved respondent's authority under section 482 to, in essence, ignore the nonrecognition provisions by treating the transferee corporations as having planted and incurred the expenses of growing the crops.

Several of the factors mentioned above distinguish those cases from the one before us. In our case, petitioner's transfer of the intangibles in 1966 effected a change of ownership of those intangibles to Lilly P.R. Lilly P.R. did not sell or otherwise dispose of the intangibles in the year of the transfer,

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[59] Contra *Heaton v. United States*, 573 F. Supp. 12 (E.D. Wash. 1983); *Fanning v. United States*, 568 F. Supp. 823 (E.D. Wash. 1983). In each of those cases, the District Court held the Commissioner abused his discretion in allocating planting expenses claimed by individual farmers to their newly formed farm corporation because the farmers, unlike the taxpayers in *Central Cuba Sugar* and *Rooney*, did not generate a net operating loss.

[60] In *Central Cuba Sugar*, the taxpayer received from the Service an advance ruling under the predecessor of sec. 367 that the proposed transaction was "not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes."

or in any other year, but held them and used them in the active conduct of its business of manufacturing and selling Darvon and Darvon-N products.[61] It is the income from the conduct of that business in 1971, 1972, and 1973, *not* the income (or loss) realized upon the disposition of the transferred assets, that respondent is attempting to allocate from Lilly P.R. to petitioner.

Respondent's reallocations conflict with a fundamental principle of Federal income tax law: that income from property is earned by the owner of the property. See *Helvering v. Horst*, 311 U.S. 112 (1940); *Blair v. Commissioner*, 300 U.S. 5 (1937). This principle is recognized by the regulations under section 482 at section 1.482–1(b)(1), Income Tax Regs. That section provides that "the purpose of section 482 is to place a controlled taxpayer on a parity with an uncontrolled taxpayer by determining * * * the true taxable income *from the property and business* of a controlled taxpayer." (Emphasis added.) Therefore, the income produced by Lilly P.R. attributable to its use of the transferred property cannot be allocated to petitioner under section 482 because it is income *earned* by Lilly P.R. from the use of *its* property in *its* business.

Our conclusion is supported by *Bank of America v. United States*, an unreported case (N.D. Cal. 1979, 44 AFTR 2d 79–5013, 79–1 USTC par. 9170). In that case, a wholly owned subsidiary transferred the assets of its foreign branches to its parent bank in consideration for the parent's assumption of the branches' liabilities plus the payment of an additional amount of cash. The transaction qualified for nonrecognition treatment under section 311. The parent bank did not dispose of the branches but continued to operate them. The District Court for the Northern District of California rejected the Commissioner's attempt to allocate income from the parent to the subsidiary under section 482. The Court stated that:

> No * * * distortion of income [is] produced by this transfer which is not sanctioned by section 311. The income from the branches goes to the [parent] instead of to [the subsidiary] but that is because the income producing capital assets were transferred. [44 AFTR 2d at 79–5106, 79–1 USTC par. 9170, at 86,253.]

[61] The level of activity carried on by Lilly P.R. and the amount of its capital investment were set out in detail in our findings of fact. No purpose would be served by restating that information here.

Moreover, we note that nothing in *National Securities Corp. v. Commissioner, supra*, is to the contrary. In that case, the Commissioner conceded, and the Court concurred, that the subsidiary was entitled to deduct that portion of the loss on the sale of the transferred stock sustained after the section 351 transfer of that stock.

Finally, *Central Cuba Sugar* and *Rooney* each involved the mismatching of income and expenses occurring within a single taxable year. The mismatching resulted from the transfer of a crop midway through the taxable year. The expenses of growing the crop were paid by the transferor and the transferee had only to sell the crop to realize the income. Respondent argues that petitioner's transfer of the intangibles to Lilly P.R. under section 351 without reimbursement for the expenses incurred in connection with the research and development of Darvon and Darvon-N created a distortion of income. However, no mismatching of income and expenses, as occurred in *Central Cuba Sugar* and *Rooney*, resulted from petitioner's 1966 transfer of patents and know-how to Lilly P.R. The income in question was income earned by Lilly P.R., using the patents and know-how in its business during 1971, 1972, and 1973. The only expenses of petitioner even remotely related to that income were the expenditures petitioner incurred in developing the patents and know-how, largely in the 1950s. Those expenditures were incurred by petitioner not only long before the years in issue but also long before the 1966 transfer. Moreover, the net income earned by petitioner from the manufacture and sale of Darvon products during the years prior to the transfer, greatly exceeded petitioner's research and development expenses related to Darvon and Darvon-N products during that period.[62] Clearly, all expenses related to petitioner's research and development of the Darvon and

[62]Petitioner's research and development expenses related to Darvon and Darvon-N products for the years 1951 through 1966 were $3,168,000 (see p. 1084). That figure, however, does not include the expenses during that period for propoxyphene-related clinical grants. Petitioner's best estimate of the amounts expended for those clinical grants during the years 1951 through 1957 is $200,000 per year, or $1,400,000 for the 7-year period. Petitioner estimates that its propoxyphene-related clinical grants for the years 1958 through 1966 averaged $1 million per year, or $9 million for the 9-year period. Petitioner's total propoxyphene-related research and development expenses, therefore, were approximately $13,568,000. Petitioner's net income before taxes on U.S. sales of Darvon products for the years 1958 through 1966 totaled $155,100,000. (See p. 1009.) (1966 sales of Darvon included some sales by Lilly P.R.)

Darvon-N intangibles were recovered by petitioner prior to the transfer of those intangibles.

In any event, we believe the expenses giving rise to the development of the patents and know-how simply are too remote in time to be matched with the income earned by Lilly P.R. during the years in issue.[63] To attempt to match income and expenses at this point would cause a distortion of petitioner's income no less severe than that which respondent seeks to remedy by his application of section 482. Petitioner's transfer of intangibles to Lilly P.R. did not create a mismatching of income and expenses, and respondent's actions disregarding that transfer were improper.

iii. *Substance Over Form*

Respondent maintains that our conclusion would effectively foreclose his application of section 482 whenever a domestic parent transfers property to a subsidiary. Respondent argues that, although he is not attacking the validity of the section 351 transfer, he is authorized by section 482 to allocate the income from the transferred property back to petitioner. In essence, respondent is making the ubiquitous "substance over form" argument: he acknowledges the valid "form" of the transaction but challenges the "substance" thereof because of the alleged income distortion resulting from the transfer. Quoting extensively from *Gregory v. Helvering*, 293 U.S. 465 (1935), and its progeny, respondent contends that the technical form of a transaction cannot control its true nature where that form does not accord with economic reality.

We find that both the form and the substance of petitioner's transfer of assets to Lilly P.R. comported with economic reality. Petitioner transferred patents and know-how to its newly formed subsidiary, Lilly P.R., by its Assignment of Patents and Related Technical Data dated December 5, 1966. Such a transfer of intangibles to a wholly owned subsidiary is a common section 351 transaction. See sec. 1.351–1(a)(2), example (*1*), Income Tax Regs., relating to a section 351 transfer of a patent, which has been part of the regulations for over 50 years. See art. 1572(c), Regs. 65. As pointed out in Rev. Rul. 64–56, 1964–1 C.B. (Part 1) 133, the establishment of a

[63] We do not imply that respondent's authority to invoke sec. 482 is limited to within a 1 year period. See *G.U.R. Co. v. Commissioner*, 117 F.2d 187 (7th Cir. 1941), affg. 41 B.T.A. 223 (1940).

new subsidiary to conduct manufacturing operations outside the United States typically involves the transfer of manufacturing intangibles to the subsidiary.

Petitioner's assignment transferred ownership of the patents and know-how in substance as well as in form. The assignment was ratified by the boards of directors of petitioner and Lilly P.R. on December 19, 1966. The assignment was recorded in the U.S. Patent Office on February 14, 1969. After the transfer of the patents and know-how on December 5, 1966, and during the years in issue, Lilly P.R. was the only manufacturer of Darvon and Darvon-N products in the United States and Puerto Rico and, therefore, was the only user of the patents and know-how in those locations. Moreover, after the 1966 transfer of the patents and know-how, Lilly P.R. initiated two patent infringement suits in its own name to protect the propoxyphene patent and bore the cost of prosecuting those suits. Under patent law, only the owner of a patent may sue for infringement of that patent. *Waterman v. Mackenzie*, 138 U.S. 252 (1891).

Additionally, respondent's argument, that petitioner, having originally developed the patents and know-how, is forever required to report the income from those intangibles, is without merit. Respondent ignores the fact that petitioner, as developer and owner of the intangible property, was free to and did transfer the property to Lilly P.R. in 1966. Respondent's case actually is based upon his belief that because petitioner could have retained the ownership of the patents and know-how and realized all the income attributable thereto, petitioner's transfer of the ownership of the patents and know-how can be ignored for income tax purposes. That argument was rejected by this Court 40 years ago. In overturning a section 482 allocation in *Seminole Flavor Co. v. Commissioner*, 4 T.C. 1215, 1235 (1945), we stated:

> Actually, the principal force behind all of the Commissioner's argument is that the petitioner could as well have done all the things that the partnership did and reaped all of the earnings of the related enterprises. *Since petitioner could have had the earnings, the Commissioner would make it so by exercising the authority conferred by [the predecessor of section 482].* The same type of argument was made in the *Koppers* case, *supra*, which rejected the argument in language equally apt to the present contention
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"The answer to this argument is that petitioner did not do this. It was free to and did use its funds for its own purposes. It was under no obligation to so arrange its affairs and those of its subsidiary as to result in a maximum tax burden. On the other hand, it had a clear right by such a real transaction to reduce that burden."

[Emphasis added and citations omitted.]

The above reasoning in *Seminole Flavor* has been consistently applied in later cases. See *Hospital Corp. of America v. Commissioner*, 81 T.C. 520, 583 (1983); *Polak's Frutal Works, Inc. v. Commissioner*, 21 T.C. 953, 976 (1954). Accordingly, we will not disregard petitioner's transfer of the intangibles to Lilly P.R. on the basis of substance over form.

b. *Arm's-Length Consideration*

Notwithstanding the fallacies of respondent's other arguments,[64] he is authorized under section 482 to make allocations between petitioner and Lilly P.R. if necessary clearly to reflect their respective incomes. *Baldwin-Lima-Hamilton Corp. v. United States*, 435 F.2d 182 (7th Cir. 1970). Respondent argues that petitioner's transfer of valuable income-producing intangibles under section 351 to Lilly P.R., without receiving arm's-length consideration as defined under section 1.482-2(d)(2), Income Tax Regs., for such intangibles, created a distortion of income. On the other hand, petitioner contends that section 351 permits a tax-free transfer of the intangibles, and that any distortion which results was contemplated and authorized by Congress.

Although we agree with petitioner that the purpose of section 351 is to facilitate the incorporation of businesses,[65] we

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[64] In addition to the arguments discussed above, respondent argues that petitioner's transfer of the intangibles should be ignored for sec. 482 purposes under *Foglesong v. Commissioner*, 621 F.2d 865 (7th Cir. 1980), revg. and remanding a Memorandum Opinion of this Court, on remand, 77 T.C. 1102 (1981), revd. 691 F.2d 648 (7th Cir. 1982). We, however, find *Foglesong* clearly distinguishable from the present case. In *Foglesong* the Seventh Circuit held that a sec. 482 allocation of income from a one-man personal service corporation to the shareholder-employer was improper because the taxpayer as employee could not be considered a separate trade or business. Respondent's determinations herein do not involve allocations of income and deductions from a personal service corporation to the sole shareholder-employer. Accordingly, *Foglesong* is not on point and does not control disposition of the issues in the present case. *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), affd. 445 F. 2d 985 (10th Cir. 1971); *Arnwine v. Commissioner*, 76 T.C. 532, 544-545 (1981).

[65] See *Portland Oil Co. v. Commissioner*, 109 F.2d 479, 488 (1st Cir. 1940), affg. 38 B.T.A. 757 (1938):

"It is the purpose of [the predecessor of section 351] to save the taxpayer from an immediate recognition of gain, or to intermit the claim of a loss, in certain transactions where the gain or loss may have accrued in a constitutional sense, but where in a popular economic sense there has been

recognize that section 482 authorizes respondent to make allocations among related taxpayers clearly to reflect income even in the context of a nonrecognition provision. However, the mere existence of a section 351 transfer of property does not, per se, require a section 482 allocation by respondent. Accordingly, we must decide whether the prices Lilly P.R. charged petitioner for Darvon and Darvon-N products during 1971, 1972, and 1973 caused an unclear reflection of income. For the reasons set forth below, we believe they did.

Respondent maintains that, because petitioner did not receive arm's-length consideration as defined in section 1.482–2(d)(2), Income Tax Regs., in exchange for its transfer of the propoxyphene and napsylate patents in 1966, he can totally disregard the transfer in making pricing allocations for the years in issue. In support of his argument, respondent relies on section 1.482–2(d), Income Tax Regs., which specifically addresses the transfer of intangible property to a related party for other than an arm's-length consideration. Section 1.482–2(d)(1)(i), Income Tax Regs., provides:

> (d) *Transfer or use of intangible property.*—(1) *In general.* (i) Except as otherwise provided in subparagraph (4) of this paragraph, where intangible property or an interest therein is transferred, sold, assigned, loaned, or otherwise made available in any manner by one member of a group of controlled entities (referred to in this paragraph as the transferor) to another member of the group (referred to in this paragraph as the transferee) for other than an arm's length consideration, *the district director may make appropriate allocations to reflect an arm's length consideration for such property or its use. Subparagraph (2) of this paragraph provides rules for determining the form an amount of an appropriate allocation*, subparagraph (3) of this paragraph provides a definition of "intangible property", and subparagraph (4) of this paragraph provides rules with respect to certain cost-sharing arrangements in connection with the development of intangible property. For purposes of this paragraph, an interest in intangible property may take the form of the right to use such property. [Emphasis added.]

Section 1.482–2(d)(2)(i), Income Tax Regs., defines arm's-length consideration as royalties, lump-sum payments, or any other form, including reciprocal licensing agreements, consistent with the form adopted by unrelated parties.[66] Although

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a mere change in form of ownership and the taxpayer is not really 'cashed in' on the theoretical gain or closed out of a losing venture."

[66] Sec. 1.482–2(d)(2)(i), Income Tax Regs., provides:

> (2) *Arm's length consideration.* (i) An arm's length consideration shall be in a form which is

respondent may have utilized this regulation to impute a royalty or lump-sum payment from Lilly P.R. to petitioner, he chose not to do so. Instead, respondent argues that the regulation supports his disregarding completely the 1966 transfer in determining arm's-length prices during 1971, 1972, and 1973. With this we disagree.

Respondent has no authority under section 1.482–2(d), Income Tax Regs., to disregard completely the 1966 transfer. We emphasize that respondent is not attempting to impose a royalty or lump-sum payment upon Lilly P.R. under this regulation. Were he to do so, he most certainly would recognize the transfer and allow Lilly P.R. a return on the manufacturing intangibles after payment of the royalties or lump sum. Indeed, both parties agree that this is a *pricing* case and that, for purposes of determining arm's-length prices, section 1.482–2(e), Income Tax Regs., controls. Accordingly, we believe that respondent's use of section 1.482–2(d), Income Tax Regs., to disregard completely petitioner's transfer of intangibles is inappropriate. We do believe, however, that the lack of a royalty, lump-sum payment, or bona fide cost-sharing arrangement is a relevant factor to be considered in determining arm's-length prices between Lilly P.R. and petitioner during 1971, 1972, and 1973.

Although we reject respondent's argument that the ownership of the intangibles should be disregarded in making pricing allocations, we agree with him that, during the years in issue, there was a distortion of petitioner's income warranting reallocations of income from Lilly P.R. to petitioner.

The distortion of income in this case was caused primarily because petitioner's transfer of the intangibles to Lilly P.R., without receiving arm's-length consideration as defined in the regulations under section 482, enabled it, through the mechanism of intercorporate pricing, to shift profits to Lilly P.R.

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consistent with the form which would be adopted in transactions between unrelated parties under the same circumstances. To the extent appropriate, an arm's length consideration may take any one or more of the following forms: (a) royalties based on the transferee's output, sales, profits, or any other measure; (b) lump-sum payments; or (c) any other form, including reciprocal licensing rights, which might reasonably have been adopted by unrelated parties under the circumstances, provided that the parties can establish that such form was adopted pursuant to an arrangement which in fact existed between them. However, where the transferee pays nominal or no consideration for the property or interest therein and where the transferor has retained a substantial interest in the property, an allocation shall be presumed not to take the form of a lump-sum payment.

Petitioner, a pharmaceutical company, competes in a research-intensive industry and spends a substantial amount of its annual budget on ongoing research and development. Such expenditures yield relatively few marketable products. Pharmaceutical companies, including petitioner, are dependent upon the profits derived from the few marketable products they invent to fund their current research and development functions. In the instant case, the prices petitioner paid Lilly P.R. for the Darvon and Darvon-N products did not enable petitioner to realize sufficient profit to fund a proportionate share of its ongoing research and development expenses. Had petitioner been dealing with an unrelated third party at arm's length, the fact that it did not receive arm's-length consideration for the transfer of the intangibles would have been reflected in lower prices from the transferee to petitioner, thus permitting petitioner to realize more profit. That this is true is illustrated by the testimony of respondent's expert accounting witness, Dr. James Wheeler. Dr. Wheeler testified that, if petitioner had transferred to Lilly P.R. the rights to manufacture its nine most profitable products and had purchased those products from Lilly P.R. at prices consistent with the prices it paid for the Darvon and Darvon-N products, petitioner would have been operating at a loss.

It is inconceivable that petitioner, negotiating at arm's length, would have transferred valuable income-producing intangibles without a royalty, lump-sum payment, or other agreement that would enable petitioner to continue its general research and development activities. In the absence of such an agreement, petitioner was able to structure its pricing so as to divert needed profits to Lilly P.R. Accordingly, we must conclude that the prices petitioner paid Lilly P.R. did cause a distortion of income which respondent may correct by making appropriate allocations under the authority of section 482. We must now determine whether respondent's allocations are arbitrary, capricious, or unreasonable.

Issue 2. Respondent's Section 482 Adjustments

Section 482 gives respondent authority to allocate income between or among related corporations when necessary to prevent the evasion of taxes or clearly to reflect the income of such corporations. The purpose of section 482 is to place a

controlled taxpayer on a tax parity with an uncontrolled taxpayer. See sec. 1.482–1(b)(1), Income Tax Regs.

Respondent's determination as set forth in the notice of deficiency is presumptively correct, and the burden of disproving that determination lies with petitioner. Rule 142(a),[68] *Welch v. Helvering*, 290 U.S. 111 (1933). The burden of proving the increases in deficiencies alleged in the amended answer, however, is on respondent. Rule 142(a).

In addition to the general presumption of correctness that attaches to respondent's determination, respondent has broad discretion in his application of section 482 (*Spicer Theatre, Inc. v. Commissioner*, 346 F.2d 704, 706 (6th Cir. 1965), affg. 44 T.C. 198 (1964)), so that his determination will be upheld unless petitioner proves it to be arbitrary, capricious, or unreasonable.[69] See, e.g., *Phillip Bros. Chemicals, Inc. (N.Y.) v. Commissioner*, 435 F.2d 53, 57 (2d Cir. 1970), affg. *Phillip Bros. Chemicals, Inc. (Md.) v. Commissioner*, 52 T.C. 240 (1969); *Ach v. Commissioner*, 42 T.C. 114, 125–126 (1964), affd. 358 F.2d 342 (6th Cir. 1966); *Grenada Industries, Inc. v. Commissioner*, 17 T.C. 231, 255 (1951), affd. 202 F.2d 873 (5th Cir. 1953); *National Securities Corp. v. Commissioner*, 46 B.T.A. 562, 565 (1942), affd. 137 F.2d 600 (3d Cir. 1943). Our decision as to whether or not respondent has exceeded or abused his discretion turns upon questions of fact. See, e.g., *Ballentine Motor Co. v. Commissioner*, 324 F.2d 796 (4th Cir. 1963), affg. 39 T.C. 348 (1962); *American Terrazzo Strip Co. v. Commissioner*, 56 T.C. 961 (1971).

Should petitioner prove respondent's determination to be arbitrary, capricious, or unreasonable, the general presumption of correctness no longer applies. See, e.g., *Woodward Governor Co. v. Commissioner*, 55 T.C. 56 (1970). Petitioner also may overcome the presumption by introducing sufficient evidence proving that the transactions in issue satisfied the arm's-length standard of section 482. In the event that petitioner does overcome respondent's presumption of correctness and disproves the deficiencies set forth in the statutory notice, we must determine from the record before us the

[68] All Rule references are to the Tax Court Rules of Practice and Procedure.

[69] The fact that some cases express the taxpayer's burden of proof in the conjunctive rather than the disjunctive is of no consequence as the terms used are synonymous. See *Foster v. Commissioner*, 80 T.C. 34, 142 n. 59 (1983), affd. on this issue 756 F.2d 1430 (9th Cir. 1985).

proper allocations, if any, of income between petitioner and Lilly P.R. See *Nat Harrison Associates, Inc. v. Commissioner*, 42 T.C. 601, 617 (1964); *Ach v. Commissioner, supra*. As we stated in *Nat Harrison*, "this Court may allocate income under the statute in a manner the evidence before us demonstrates to be correct and * * * respondent's allocation need not be approved or disapproved *in toto*." 42 T.C. at 617–618.

Petitioner argues that, because respondent has espoused different section 482 determinations supported by totally disparate methodologies, respondent's determinations are arbitrary, capricious, and unreasonable. We disagree.

In the notice of deficiency, respondent's determination was based upon a method which allowed Lilly P.R. its cost of goods sold, location savings, and a gross profit for each of the Mayaguez and Carolina manufacturing facilities. In his amended answer, respondent asserted increased deficiencies by eliminating the intra-company profit on the transfer of chemicals from the Mayaguez to the Carolina facility and allowing Lilly P.R. a gross profit equal to 30 percent of manufacturing costs and location savings. At trial, respondent relied on his expert witness Dr. William S. Comanor who did not testify regarding the methods used in the notice of deficiency or amended answer. Instead, Dr. Comanor used two other methods for allocating income which involved averages of third-party prices and gross profits.

There are often occasions when, in order to protect the revenue, respondent must make alternative determinations. *Nat Harrison Associates, Inc. v. Commissioner, supra* at 617. Moreover, as respondent's counsel argued at trial, to lock him into one exact methodology or calculation would require the Service to retain an expert at the time of mailing the deficiency notice, a requirement which would effectively preclude it from ever using outside experts. Accordingly, we do not think that because respondent made alternative determinations supported by differing methodologies, his actions were arbitrary, capricious, or unreasonable. See *Nat Harrison Associates, Inc. v. Commissioner, supra*. Thus, the presumption of correctness would not be lost for that reason, alone.

Although we do not take issue with respondent's conclusion that, during the years in issue, there was a distortion of income justifying some reallocation, we do disagree with

respondent's determination of the amount of income to be allocated. In making the various allocations of income from Lilly P.R. to petitioner, respondent never permitted Lilly P.R. any income attributable to the manufacturing intangibles[70] which it owned and utilized in the manufacture of the Darvon and Darvon-N products. Because we have found Lilly P.R. is entitled to the income attributable to those intangibles, we must conclude that respondent's determination, which denied Lilly P.R. *any* income from the manufacturing intangibles, was unreasonable. *Baldwin-Lima-Hamilton Corp. v. United States*, 435 F.2d 182, 187 (7th Cir. 1970); *American Terrazzo Strip Co. v. Commissioner*, 56 T.C. 961, 973 (1971); *P.P.G. Industries, Inc. v. Commissioner*, 55 T.C. 928, 993 (1970); *Nat Harrison Associates, Inc. v. Commissioner, supra* at 617–618; *Seminole Flavor Co. v. Commissioner*, 4 T.C. 1215, 1235 (1945). We must therefore make a determination of the proper allocation of income from Lilly P.R. to petitioner, without the benefit of any presumptions, in a manner the evidence before us demonstrates to be correct. *American Terrazzo Strip Co. v. Commissioner, supra; Nat Harrison Associates, Inc. v. Commissioner, supra; Ach v. Commissioner, supra* at 126.

Issue 3. Determination of Arm's-Length Prices Between Petitioner and Lilly P.R.

We turn now to the third and final issue of this case: whether Lilly P.R.'s prices to petitioner for the Darvon and Darvon-N products sold by it during the years in question were prices at which those products would have been sold between unrelated parties dealing at arm's length. We have found that Lilly P.R. is the owner of, and entitled to, the income from the manufacturing intangibles. Consequently, we must determine the applicable arm's-length prices from all the evidence submitted by the parties, and, if necessary, we may make our own best estimate as to the proper amounts under the principles of *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930),

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[70]The income attributable to the manufacturing intangibles is, by definition (see our discussion at p. 1151), the excess of Lilly P.R.'s net operating profit over its manufacturing profit and location savings. Our determination that petitioner's intercorporate pricing structure caused a distortion of income, necessitates a downward adjustment in the prices petitioner paid Lilly P.R. for the Darvon and Darvon-N products. Such an adjustment results in a commensurate diminution of Lilly P.R.'s income attributable to the manufacturing intangibles.

modifying 11 B.T.A. 743 (1928). See *Nat Harrison Associates, Inc. v. Commissioner*, 42 T.C. 601 (1964); *Ach v. Commissioner*, 42 T.C. 114 (1964).

A. *Section 482 Regulations*

1. *1971 and 1972 Taxable Years*

Section 1.482-2(e)(1)(i), Income Tax Regs., provides that, when one controlled entity sells tangible property to another controlled entity at "other than an arm's length price," respondent may "make appropriate allocations between the seller and the buyer to reflect an arm's length price for such sale." An "arm's length price" for purposes of that section is defined as:

> the price that an unrelated party would have paid under the same circumstances for the property involved in the controlled sale. Since unrelated parties normally sell products at a profit, an arm's length price normally involves a profit to the seller. [Sec. 1.482–2(e)(1)(i), Income Tax Regs.]

The regulations set forth three detailed methods for determining an arm's-length price: the comparable uncontrolled price method, the resale price method, and the cost plus method. Sec. 1.482–1(e)(1)(ii), Income Tax Regs. A fourth method is provided by the following language in section 1.482–2(e)(1)(iii), Income Tax Regs.:

> Where the standards for applying one of the three methods of pricing * * * are met, such method must, for the purposes of this paragraph, be utilized unless the taxpayer can establish that, considering all the facts and circumstances, some method of pricing other than those described * * * is more appropriate. *Where none of the three methods of pricing * * * can reasonably be applied under the facts and circumstances as they exist in a particular case, some appropriate method of pricing other than those described * * *, or variations on such methods, can be used.* [Emphasis added.]

Petitioner argues that the prices charged it by Lilly P.R. for the years 1971 and 1972 satisfy the resale price method or a variation of such method. Respondent, apart from his other arguments concerning his own pricing formulas (which, as we already have held, erroneously failed to allocate any income

attributable to the manufacturing intangibles to Lilly P.R.),[71] argues that the 1971 and 1972 prices did not satisfy the resale price method because the appropriate markup was determined by reference to petitioner's own sales of other products. Respondent also alleges that petitioner's allocations of income and expenses between petitioner and Lilly P.R. with respect to Darvon and Darvon-N products were erroneous. For the reasons stated below, we agree with respondent.

a. *Pricing Methods*

Section 1.482–2(e)(1)(ii), Income Tax Regs., establishes a priority for the application of the pricing methods listed above. The comparable uncontrolled price method is the most accurate of the methods, and is to be used whenever there are "comparable uncontrolled sales." Comparable uncontrolled sales are sales of the same or substantially identical property between uncontrolled buyers and sellers. Sec. 1.482–2(e)(2), Income Tax Regs. The resale price method is to be used if there are no comparable uncontrolled sales. Sec. 1.482–2(e)(1)(ii), Income Tax Regs. That method involves calculating an appropriate markup by which the resale price to an uncontrolled buyer is reduced to find the arm's-length price for the controlled sale. Sec. 1.482–2(e)(3), Income Tax Regs.

The cost plus method starts from the other end. Instead of reducing the sales price of the reseller (marketing company) by an appropriate markup, the cost plus method requires the determination of an appropriate gross profit, which is added to the seller's (manufacturer's) cost of producing such property. Sec. 1.482–2(a)(4), Income Tax Regs.

If none of the above methods is viable under the facts of a particular case, a fourth "appropriate" method may be used. Sec 1.482–2(e)(1)(iii), Income Tax Regs.

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[71] Respondent advocates a "functional analysis" of petitioner's and Lilly P.R.'s activities vis-à-vis general pharmaceutical companies' operations. Respondent separates the functions performed into (1) research and development, (2) manufacturing, and (3) marketing. He argues that petitioner did all of (1) and (3), and part of (2), but was never reimbursed fully for the services and materials provided to Lilly P.R. Respondent thus recomputes their "true taxable income" based upon the functions performed by each over a period of more than 25 years. Respondent's argument ignores the fact that income is earned not only through the performance of specified functions, but also through the use of tangible and intangible property in the performance of such functions. Thus, respondent has disregarded a fundamental principle of taxation that income from property is earned by the owner of the property. This principle is recognized in sec. 1.482–1(b), Income Tax Regs., which provides that the purpose of sec. 482 is to determine the "true taxable income from the property and business of a controlled taxpayer."

i. *Comparable Uncontrolled Price Method*

During the years 1971 and 1972, there were no comparable uncontrolled sales of Darvon and Darvon-N products in the United States. Because of the existence of the propoxyphene and napsylate patents, no one other than Lilly P.R. could manufacture or sell Darvon or Darvon-N products in the United States.[73] Although the record does disclose that sales of propoxyphene in bulk form took place outside the United States in markets that were not covered by U.S. patent protection, those sales were not comparable uncontrolled sales because they occurred in a different, unprotected market. Moreover, no sales were found of the final dosage form of the product at a comparable distribution level.

During the years in issue, Darvon and Darvon-N products were among the 10 largest selling ethical pharmaceutical products in the United States. Darvon and Darvon-N products were prescribed for the relief of mild to moderate pain, and their principal competitors were combinations of codeine with either aspirin or acetaminophen. Those combinations were not substantially identical to Darvon and Darvon-N products. Therefore, no comparable uncontrolled sales of Darvon and Darvon-N products are available for 1971 and 1972.

ii. *Resale Price Method*

The next pricing method prescribed by the regulations under section 482 is the resale price method. The regulations provide that the arm's-length price of a controlled sale determined using the resale price method is equal to "the applicable resale price * * * reduced by an appropriate markup" (sec. 1.482–2(e)(3)(i), Income Tax Regs.), and adjusted "to reflect any material differences between the uncontrolled purchases and resales used as the basis for the calculation of the appropriate markup percentages and the resales of property involved in the controlled sale. The differences referred to * * * are those differences in functions or circumstances

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[73] A patent owner has three exclusive rights under a patent: the right to manufacture, use, and sell the patented product. 35 U.S.C. sec. 154. However, once the product is sold by the patent owner to a third-party purchaser, such as petitioner in this case, the purchaser acquires the right to resell the product. *Duplan Corp. v. Deering Milliken, Inc.*, 444 F. Supp. 648 (D.S.C. 1977), affd. in part, revd. in part on other grounds 594 F.2d 979 (4th Cir. 1979).

which have a definite and reasonably ascertainable effect on price." Sec. 1.482–2(e)(3)(ix), Income Tax Regs.

The " 'applicable resale price' is the price at which it is anticipated that property purchased in the controlled sale will be resold by the buyer in an uncontrolled sale. The 'applicable resale price' will generally be equal to either the price at which current resales of the same property are being made or the resale price of the particular item of property involved." Sec. 1.482–2(e)(3)(iv), Income Tax Regs. In this case, the applicable resale price is petitioner's sales price to its unrelated customers, i.e., its wholesale distributors. The "appropriate markup" is the gross profit, expressed as a percentage of sales, "earned by the buyer (reseller) or another party on the resale of property which is both purchased and resold in an uncontrolled transaction, which resale is most similar to the applicable resale of the property involved in the controlled sale." Sec. 1.482–2(e)(3)(vi), Income Tax Regs.

Prior to the publication of the regulations under section 482, petitioner adopted an approach similar to the resale price method by attempting to measure an appropriate margin to petitioner for the resale of Darvon and Darvon-N products and by calculating that margin as a percentage discount from petitioner's net wholesale prices. Petitioner contends that the discounts granted by Lilly P.R. to petitioner were comparable to discounts which would have prevailed had the parties been unrelated and dealing at arm's length. Petitioner thus asserts that the discounts constituted an appropriate markup within the meaning of the resale price method.

In support of its position, petitioner submitted the testimony of three economic experts: Dr. Yale Brozen of the University of Chicago Graduate School of Business, and Drs. William J. Baumol and Charles H. Berry of Princeton University. Respondent submitted the testimony of economic expert Dr. William S. Comanor of the University of Southern California at Santa Barbara. We found all these individuals qualified in the field of economics for the purposes of rendering expert opinions.

Petitioner's economic experts were retained in this case to analyze the intercompany transfer pricing arrangement between petitioner and Lilly P.R. The experts testified individually, but they submitted a joint report stating their group

analyses and conclusions. Unless otherwise indicated, we will refer to petitioner's economic experts, Drs. Brozen, Baumol, and Berry, in the collective.

Petitioner's experts concluded that the transfer prices charged by Lilly P.R. for its Darvon and Darvon-N products during 1971 and 1972 were considerably less than the transfer prices that would have been charged between unrelated parties.[73] Petitioner's experts also concluded that the transfer prices proposed by respondent were undefensibly low and completely unrelated to prices that would have been charged by parties dealing at arm's length.

For 1971 and 1972, petitioner's experts were unable to locate any reasonably comparable uncontrolled transactions involving similar products to determine an arm's-length price. They thus concluded that an arm's-length price should be determined by reference to the profit generating assets and activities of each of the related companies. The assets and activities relative to Darvon and Darvon-N products considered by the experts were as follows:

Petitioner	*Lilly P.R.*
1. Market activity and tangible assets	1. Manufacturing activity and tangible manufacturing assets
2. Intangible assets	2. Intangible assets
a. Petitioner's name	a. Propoxyphene patent—expired at end of 1972
b. Petitioner's marketing organization	b. Napsylate patent
c. Marketing know-how	c. Process know-how
d. Darvon and Darvon-N trademarks	d. Formula know-how

Petitioner's experts correctly viewed the ownership of the manufacturing intangibles as an important factor in determining an arm's-length price. For the purposes of their analyses, the experts assumed that Lilly P.R. was the owner of the propoxyphene and napsylate patents during 1971 and 1972, and that petitioner was the owner of the Darvon and Darvon-N trademarks. Based on those assumptions, however, petition-

[73] "Less than" an arm's-length price in this situation is beneficial to petitioner inasmuch as respondent argues that Lilly P.R.'s prices were greater than arm's-length prices and, therefore, allowed petitioner to transfer too much income to Lilly P.R. See Rev. Proc. 63-10, 1963-1 C.B. 490, 491.

er could not have sold propoxyphene products under the Darvon and Darvon-N trademarks in 1971 and 1972 unless it had purchased those products from Lilly P.R. If petitioner had been unable to use the Darvon and Darvon-N trademarks in 1971 and 1972, petitioner's economic experts concluded that the value of those trademarks would have fallen substantially. In other words, the experts concluded that the intangible value was attributable primarily to the propoxyphene and napsylate patents because the initial transfer of the patents to Lilly P.R. must have carried with it the right and the power to acquire all foreseeable propoxyphene profits.

Viewed from another perspective, if Lilly P.R. had sold its propoxyphene products tc another pharmaceutical company for distribution in the United States in 1971 and 1972, that other company could have established a new trademark for Lilly P.R.'s propoxyphene products in a market environment protected by Lilly P.R.'s propoxyphene and napsylate patents from the competition of petitioner's Darvon and Darvon-N trademarks. Accordingly, in the opinion of the economic experts, the value of petitioner's Darvon and Darvon-N trademarks was minimal during the years 1971 and 1972, and the bulk of the profit contribution of intangibles related to propoxyphene products in 1971 and 1972 was attributable to the propoxyphene and napsylate patents and the other manufacturing intangibles owned by Lilly P.R.

Because the experts believed the Darvon and Darvon-N trademarks had no especially significant independent value in 1971 and 1972, they estimated an arm's-length price to petitioner in those years on the basis of the profit contribution of petitioner's marketing activities and intangible marketing assets.

Petitioner's economic experts concluded that the contribution of petitioner's intangible assets and activities related to the marketing of Darvon and Darvon-N products could best be estimated by reference to the price that petitioner would have been willing to pay Lilly P.R. for the right to market those products in the United States under the circumstances of this case. They believed that in arm's-length negotiations with Lilly P.R., petitioner would have been willing to pay Lilly P.R. a price that produced a return on its resources devoted to marketing Darvon and Darvon-N products equal to what it

could have earned by devoting those resources to the marketing of other products. To measure that return, the experts concluded that the opportunity cost to petitioner of marketing Darvon and Darvon-N products could be determined by looking at the profitability of the other products that petitioner could have promoted during the years 1971 and 1972 and, further, that the profitability of petitioner's nine leading products provided the best estimate of the maximum opportunity cost of marketing Darvon and Darvon-N products.

Petitioner's nine leading products in 1972 were (1) Keflin®, (2) Keflex, (3) Ilosone, (4) Iletin® (including Dymelor® and Tes-Tape®), (5) Loridine®, (6) V-Cillin-K®, (7) Cordran® and Cordran-N®, (8)Mi-Cebrin® and Mi-Cebrin T®, and (9) Trinsicon®.

Petitioner's economic experts examined the profitability to petitioner of those products for the period 1964 through 1973. Because petitioner, with one exception, both manufactured and sold the nine leading products,[74] in order to determine the price at which the experts believed it would have been willing to market those products, a "purchase price" had to be established. The experts established that purchase price by treating petitioner's manufacturing cost as the price to petitioner's pharmaceutical marketing division.

The economic experts' initial comparison of petitioner's nine leading products with Darvon and Darvon-N products indicated that the ratio of operating income to operating expense for Darvon and Darvon-N products was 151 percent, but that the ratio of operating income to operating expense for the nine leading products was 144 percent. Thus, the marketing of Darvon and Darvon-N products in 1971 and 1972 was about as profitable to petitioner as the marketing of the nine leading products during that same period. Petitioner's economic experts concluded that their analysis of the nine leading products provided an appropriate evaluation of all the assets owned and activities performed by petitioner in connection with the marketing of Darvon and Darvon-N products. The nine leading products were promoted by the same detail force that promoted the Darvon and Darvon-N products; they were all sold under the "Eli Lilly and Company" trade name using

[74] The exception was the raw material ingredient of Cordran products, which petitioner purchased from an unrelated third party.

petitioner's marketing organization and marketing know-how; and each of the nine leading products had its own distinctive trademark.

The economic experts concluded that the comparison of operating income to operating expense, however, clearly overstated the profit attributable solely to the marketing activities devoted to the nine leading products. The operating income figures for the nine leading products included profits attributable to petitioner's capital investment, manufacturing know-how, and patent rights associated with those products. In the case of Darvon and Darvon-N products, however, the profits attributable to the manufacturing activities and the corresponding manufacturing intangibles belonged to Lilly P.R. Petitioner's experts made a conservative adjustment to the operating incomes of the nine leading products to take into account the profits attributable to manufacturing costs and manufacturing intangibles: 30 percent of manufacturing costs and a 5-percent royalty for manufacturing intangibles. This resulted in a ratio of operating income to operating expense for the nine leading products of 99 percent.

Considering the fact that the nine leading products were petitioner's most profitable products, it was the economic experts' view that it would be more realistic to attribute a profit of 100 percent of manufacturing costs for manufacturing activity and a royalty of 10 percent of net sales for manufacturing intangibles with the remaining profit being attributable to the marketing of the product. If those adjustments were made, the calculation of the nine leading products reduced the figure of operating income to operating expense still further to 15 percent.

On the basis of that analysis, the economic experts concluded that Lilly P.R.'s transfer prices for Darvon and Darvon-N products in 1971 and 1972 were not only within the range of arm's-length prices but that petitioner earned significantly more profit from the marketing of those products in 1971 and 1972 than it could have earned by directing its resources to its other leading products. Thus, the experts concluded that Lilly P.R.'s transfer prices for 1971 and 1972 were clearly lower than arm's-length prices for those years.

Petitioner's economic experts tested the results of their analysis by using several other approaches to valuing the

manufacturing intangibles owned by Lilly P.R. in 1971 and 1972.[75] Each of those approaches produced an estimation of the profit contribution of the manufacturing intangibles owned by Lilly P.R. ranging between 30 percent and 50 percent of petitioner's sales of Darvon and Darvon-N products in 1971 and 1972.

Petitioner asserts that the approach taken by its economic experts tracks the methodology laid down by the section 482 regulations' resale price method. Petitioner argues that, because no comparable uncontrolled sales existed, its experts determined that the next best approach to estimating an arm's-length price would be to determine the price (or absent a price, the margin) at which petitioner would be willing to market the products produced by Lilly P.R., and that that approach was the equivalent of a resale price approach focusing on the gross margin and net profit of the reseller.

Petitioner argues that, by choosing petitioner's nine leading products for comparison with Darvon and Darvon-N, its experts followed the mandate of the regulations to focus on transactions, if possible, of the specific reseller involved in the controlled transaction (in this case, petitioner). See sec. 1.482–2(e)(3)(vii), Income Tax Regs. Petitioner argues further that, by focusing on those other products of petitioner, the experts were able to neutralize completely the significance of the marketing intangibles on the sale of the Darvon and Darvon-N products because petitioner sold all the nine leading products using its Eli Lilly & Co. trade name, and promoted those products by its marketing force to the same customers through the same distribution channels. In addition, each of the nine leading products had its own distinctive trademark.

On the other hand, respondent maintains that the approach taken by petitioner's economic experts does not satisfy the resale price method of section 1.482–2(e)(3), Income Tax Regs., because petitioner's nine leading products were not purchased by petitioner in uncontrolled sales. Moreover, because the

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[75] Petitioner's economic experts utilized: (1) A comparison of Darvon and Darvon-N gross profits to gross profits of all other pharmaceutical products of petitioner; (2) a comparison of Darvon and Darvon-N operating income to operating income from all other pharmaceutical products of petitioner; and (3) an analysis of 1973 prices for generic propoxyphene products sold in the United States. A fourth method, analyzing propoxyphene market prices in various foreign markets where no patent protection exists, was used, but Dr. Brozen admitted that that test was almost meaningless.

regulations provide a listing of the methods to be used in pricing cases in strict order of their priority, respondent argues that the next method, the "cost plus" method, must be used before any variation on the resale price method can be utilized. Accordingly, respondent argues that petitioner's attempted use of the resale price method is in error in this case. Apart from that "initial obstacle," respondent also finds fault with the assumptions made by the experts regarding the constructed purchase prices for the nine leading products, and with the operating income to operating expense ratios as calculated from petitioner's statements and records. We will address respondent's arguments in turn.

Respondent correctly challenges the use of the resale price method based solely on evidence of internal transactions of the reseller. Section 1.482–2(e)(3), Income Tax Regs., determines the arm's-length price of property in a controlled sale by reducing the reseller's price of the property to an uncontrolled buyer by an "appropriate markup." Subdivision (vi) of that section clearly requires that the appropriate markup percentage be calculated using gross profit percentages earned by a reseller "on the resale of property *which is both purchased and resold in an uncontrolled transaction.*" (Emphasis added.) The regulations state elsewhere their basic assumption that uncontrolled purchases and sales must be used under the resale price method. Sec. 1.482–2(e)(3)(vii), Income Tax Regs., states as follows:

> Whenever possible, markup percentages should be derived from *uncontrolled purchases and resales* of the buyer (reseller) involved in the controlled sale. * * * [Emphasis added.]

Section 1.482–2(e)(3)(viii), Income Tax Regs., provides:

> In calculating the markup percentage earned on *uncontrolled purchases and resales* * * * the same elements which enter into the computation of the sales price and the costs of goods sold of the property involved in the comparable *uncontrolled purchases and resales* should enter into such computation in the case of the property involved in the controlled purchases and resales. * * * [Emphasis added.]

And, finally, section 1.482–2(e)(3)(ix), Income Tax Regs., states:

> In determining an arm's length price appropriate adjustment must be made to reflect any material differences between the *uncontrolled purchases*

and resales used as the basis for the calculation of the appropriate markup percentage and the resales of the property involved in the controlled sale. * * * [Emphasis added.]

We recognize that there simply were no similar uncontrolled purchases and resales in 1971 or 1972.[76] Because of petitioner's failure to establish similar uncontrolled sales, the resale price method cannot be utilized to determine arm's-length prices. Subsequent case law confirms our literal reading of the regulation. In *Lufkin Foundry & Machine Co. v. Commissioner*, 468 F.2d 805 (5th Cir. 1972), revg. a Memorandum Opinion of this Court,[77] a machine manufacturing corporation sold its machinery to various wholly owned subsidiaries for resale throughout the Western Hemisphere, exclusive of the United States. The prices it charged the subsidiaries were based on discounts from list prices, as well as on commissions on net invoice prices. The Commissioner, exercising his power under section 482, allocated to the parent 50 percent of the discounts given and 50 percent of the commissions paid to the subsidiaries. In this Court, the parent introduced evidence of the reasonableness of the discounts and commissions prepared by an independent certified public accountant using data from the parent's own internal marketing arrangements. We held that the evidence was sufficient to overcome the Commissioner's presumption of correctness and, because he had failed to introduce any evidence on his own behalf, that the Commissioner had abused his discretion in making the above allocations.

Citing section 1.482–2(e), Income Tax Regs., the Court of Appeals for the Fifth Circuit reversed. In holding that evidence of the transactions of uncontrolled parties is necessary to determine an arm's-length price, the Court stated:

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[76] "Similar" in the context of the resale price method relates to the probable effect upon the markup percentage of any differences between the uncontrolled and controlled purchases and resales. Thus, close physical similarity of the property involved in the sales compared is not required under the resale price method since a lack of close physical similarity is not necessarily indicative of dissimilar markup percentages. Sec. 1.482–2(e)(3)(vi), Income Tax Regs. Darvon and Darvon-N products were among the 10 largest selling ethical pharmaceutical products in the United States during 1971 and 1972; the other largest selling products on the market apparently were marketed by their manufacturing companies, as petitioner did with its other product lines, and were not resold for marketing and distribution by an independent company.

[77] T.C. Memo. 1971–101.

> No amount of self-examination of the taxpayer's internal transactions alone could make it possible to know what prices or terms unrelated parties would have charged or demanded. We think it palpable that if the standard set by these unquestioned regulations is to be met evidence of transactions between uncontrolled corporations unrelated to Lufkin must be adduced in order to determine what charge would have been negotiated for the performance of such marketing services. [468 F.2d at 808.]

The method of determining arm's-length prices employed by petitioner's experts thus fails to satisfy the resale price method. Petitioner contends in the alternative that the methodology used by its economic experts was a permissible variation of the resale price method which was required by the particular facts of this case. Petitioner argues that, although the regulations under the resale price method call for the establishment of an appropriate markup using the actual purchases and resales of comparable property, there is no reason why this markup could not be arrived at by an analysis of the profit of products manufactured and sold, rather than of products purchased and sold. Furthermore, petitioner maintains that, although the regulations outline three methods valid in the order in which they are prescribed, the evidentiary rules for establishing any method should be applied flexibly by the Court citing *United States Steel Corp. v. Commissioner*, 617 F.2d 942 (2d Cir. 1980), revg. two Memorandum Opinions of this Court. We do not agree.

Unquestionably, there are problems with applying the regulations as they stand today;[78] however, to approve the use of variations of the methods *within* their order merely would add to the problems and confusion surrounding intercompany pricing. In addition, adopting such an approach would render the delineation of each method, and its order of priority, meaningless. Moreover, neither the Commissioner nor the taxpayers would have an objective means of determining whether or not one of the three methods applied.

iii. *Cost Plus Method*

Because the facts of the case before us do not lend them-

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[78]The following list is but a sampling of the critical commentary regarding the pricing regulations: Eustice, "Tax Problems Arising From Transactions Between Affiliated or Controlled Corporations," 23 Tax L. Rev. 451 (1968); Fuller, "Problems in Applying the 482 Intercompany Pricing Regs. Accentuated by *DuPont* Case," 52 J. Tax. 10 (1980); Fuller, "Section 482 Revisited," 31 Tax L. Rev. 475 (1976); Jenks, "Treasury Regulations Under Section 482," 23 Tax Law. 279 (1970); Simon, "Section 482 Allocations," 46 Taxes 254 (1968); Webb, "*DuPont* and *U.S. Steel* Exacerbate Section 482 Intercompany Pricing Regulations," 10 J. Corp. Tax. 152 (1983).

selves to application of the resale price method, the next method to be examined is the cost plus method described in section 1.482–2(e)(4), Income Tax Regs. The cost plus method, as previously described, is equal to the cost of producing the property plus an appropriate profit computed with reference to uncontrolled sales of similar property. It is this method that respondent urges upon us, and towards which his notice of deficiency, amendment to answer, and experts' testimony and reports are directed.

Respondent's notice of deficiency and amendment to answer used a pricing formula allowing Lilly P.R. its manufacturing cost and location savings plus a manufacturing profit.[79] Respondent's calculations, however, do not allocate to Lilly P.R. any of the income associated with its manufacturing intangibles.

Respondent's expert economic witness, Dr. William S. Comanor, examined the "functions" performed by petitioner and Lilly P.R. and attempted to determine an allowable level of profits based on those functions. Dr. Comanor used two separate methods to determine what he believed to be acceptable profits for Lilly P.R. His first method observed certain third-party prices for the sale of propoxyphene products which occurred during 1973. Based on those observations, Dr. Comanor determined a weighted average for the market prices and then determined the percent differential between those prices and the ones charged by Lilly P.R. to petitioner. Based on that percent differential, he thus determined the amounts of profit reported by Lilly P.R. which were, in his opinion, in excess of the profits that would have been earned by it had the parties been unrelated.

Dr. Comanor's second method compared Lilly P.R.'s reported gross profits with the gross profits earned by three unrelated pharmaceutical companies deemed comparable by Dr. Comanor. Dr. Comanor determined an average gross profit margin for all three companies for each of the years 1971, 1972, and 1973, and, based on those averages, he recalculated the amount of gross profits realized by Lilly P.R. as a result of its dealings with petitioner.

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[79] The two methods differ in that the notice of deficiency also allows Lilly P.R. an intracompany profit on the transfer of chemicals from the Mayaguez facility to the Carolina facility.

Dr. Comanor's pricing methods do not provide Lilly P.R. with any income from the patents and manufacturing know-how, something we have held necessary in this case. This Court is not bound by the testimony of an expert witness and must reject such testimony where the witness overlooked a significant factor in reaching his conclusion. See *South Texas Rice Warehouse Co. v. Commissioner*, 366 F.2d 890, 898 (5th Cir. 1966), affd. 43 T.C. 540 (1965). Moreover, after observing Dr. Comanor's demeanor on the witness stand, we must substantially discount his report and testimony. We therefore reject Dr. Comanor's pricing methods with respect to the 1971 and 1972 taxable years.

The regulations under section 482 were promulgated for the purpose of providing specific guidelines and a degree of certainty to the realm of intercompany pricing. 31 Fed. Reg. 10394 (1966). Such purpose would be ill-served by our use of the cost plus method herein. There is no evidence in the record (other than petitioner's attempt in 1972 to value the napsylate patent) (see page 1080), concerning the value of the manufacturing intangibles. Petitioner's economic experts assigned a possible royalty value to the napsylate patent for 1973, but did not state how they arrived at their figure or what their qualifications for valuing a pharmaceutical patent were. Respondent has not suggested any method whereby we could allocate income attributable to the intangibles to Lilly P.R. while using the cost plus method to determine arm's-length prices for the Darvon and Darvon-N products it sold. Our use of the cost plus method in such circumstances is unwarranted and we decline to use it.[80]

b. *Profit Split Approach*

We have rejected the pricing methods and conclusions advocated by petitioner's and respondent's expert witnesses, and have found the use of all three pricing methods specified by the regulations under section 482 to be inappropriate. However, based upon the evidence before us, we must determine arm's-length prices for the Darvon and Darvon-N products purchased by petitioner from Lilly P.R. during 1971 and

[80] See sec. 1.482-2(e)(3)(iii), examples (*1*) & (*2*), Income Tax Regs., where the manufacturer's use of a patent made difficult the determination of an appropriate gross profit percentage under the cost plus method.

1972. *American Terrazzo Strip Co. v. Commissioner*, 56 T.C. 961, 973 (1971); *Nat Harrison Associates, Inc. v. Commissioner*, 42 T.C. 601 (1964). Although petitioner has met its burden of proving that such arm's-length prices would allow Lilly P.R. to earn the income attributable to the manufacturing intangibles, it has not proven what these arm's-length prices would be. Consequently, we must use our best judgment in determining arm's-length prices from the evidence submitted, bearing heavily against petitioner, "whose inexactitude is of [its] own making." *Cohan v. Commissioner*, 39 F.2d 540, 544 (2d Cir. 1930); *Ach v. Commissioner*, 42 T.C. 114, 126–127 (1964).

The use of a pricing method other than the three methods previously discussed is contemplated by the regulations under section 482. The fourth method is contained in section 1.482–2(e)(1)(iii), Income Tax Regs. That section provides that:

> Where none of the three methods of pricing described in subdivision (ii) of this subparagraph can reasonably be applied under the facts and circumstances as they exist in a particular case, some appropriate method of pricing other than those described in subdivision (ii) of this subparagraph, or variations on such methods, can be used.

This provision is clearly applicable to the facts of this case. We note that a study of more than 500 U.S. companies in 1970 and 1971 indicated that 36 percent of the section 482 allocations made by Service field agents were based on some method other than the three described in the regulations. See Duerr, "Tax Allocations and International Business," Conference Board Report No. 555 (1972), portions reprinted in O'Connor & Russo, "A Study of Corporate Experience With Sec. 482," 3 Tax Adviser 526 (1972). Another study, made by the Service of its 1968 and 1969 audits involving transfer pricing, showed that agents used some other method 41 percent of the time. Treasury Department, "Summary Study of International Cases Involving Section 482 of the Internal Revenue Code (1973)," reprinted in 2 Rhoades, Income Taxation of Foreign Related Transactions 7–91 to 7–95 (1977). A third study, conducted by a private individual, was based on the experiences in 1977 of approximately 60 companies. The participants reported that, for intercompany exports audited since 1965, the Service used some other method 32 percent of the time; for those assessments that were settled, the figure rose to 35 percent. Burns,

"How IRS Applies the Intercompany Pricing Rules of Section 482; A Corporate Survey," 52 J. Tax. 308 (1980).

While the other methods mentioned by the companies consist of everything from customs valuations to royalty agreements, the method most widely recognized by courts is the reasonable profit split approach. A leading case in this area is *PPG Industries, Inc. v. Commissioner*, 55 T.C. 928 (1970).[81] In *PPG*, respondent allocated to the taxpayer a portion of the income of PPGI, its wholly owned foreign subsidiary, from sales of glass products. As an indication of the arm's-length nature of its sales to PPGI, the taxpayer introduced evidence of the reasonableness of the net profits earned on those sales.[82] This Court determined that "When the profit earned by both [the taxpayer] and PPGI on export sales is combined to give us a consolidated export sales figure * * * it appears PPGI is only receiving a fair percent of such consolidated profit." 55 T.C. at 997. The profit split was about 55 percent to the taxpayer and 45 percent to PPGI. We stated further:

> The relevance in sec. 482 cases of the division of profits realized on export sales is illustrated in *Eli Lilly & Co. v. United States*, 372 F.2d 990 (Ct. Cl. 1967), where the court, in upholding the reallocation of profits between a domestic parent and its Western Hemisphere corporation subsidiary, pointed out that prior to the reallocation the subsidiary received a share of total profits from Western Hemisphere sales ranging from 92.84 percent of 97.68 percent while the parent corporation's share of such profits ranged from 0.61 percent to 5.65 percent, whereas after the reallocation the subsidiary's share of the profits ranged from 62.07 percent to 74.56 percent while the parent corporation's share increased to a range of from 22.90 percent to 28.30 percent. (A second subsidiary was also involved in the reallocation of profits.) [55 T.C. at 997 n. 10.]

This Court again approved a profit split in *Lufkin Foundry & Machine Co. v. Commissioner*, T.C. Memo. 1971–101, revd. 468 F.2d 805 (5th Cir. 1972). There the taxpayer showed, through the analyses of a certified public accountant, that about 52 percent of the combined profit was income to Lufkin

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[81] See also *Baldwin-Lima-Hamilton Corp. v. United States*, 435 F.2d 182, 185 (7th Cir. 1970), affg. in part an unreported District Court opinion; *Woodward Governor Co. v. Commissioner*, 55 T.C. 56, 66 (1970); *Nat Harrison Associates, Inc. v. Commissioner*, 42 T.C. 601, 622 (1964); *Eli Lilly & Co. v. United States*, 372 F.2d 990, 997 (Ct. Cl. 1967).

[82] The taxpayer also introduced sufficient evidence to satisfy the comparable uncontrolled price method. *PPG Industries, Inc. v. Commissioner*, 55 T.C. 928, 993–995 (1970).

and 48 percent was income to its selling subsidiaries. Lufkin, however, introduced no evidence of uncontrolled transactions, and this Court relied solely upon the reasonable profit split analysis.[83] The Service decided to appeal the decision[84] and the Court of Appeals for the Fifth Circuit reversed on the ground that "No quantum of evidence as to a taxpayer's internal transactions with its own subsidiaries, standing alone, [can] be sufficient to establish arm's-length dealing between them." 468 F.2d at 805. In its discussion of arm's-length pricing, however, the Court of Appeals stated briefly that the three pricing methods prescribed by the regulations under section 482 required evidence of the transactions of uncontrolled parties, then went on to say:

> [section 1.482–2(e)(1)(iii)] states that where the standards set out in the regulations indicate that one of the three methods is applicable, the taxpayer may avoid its application only by demonstrating that some other pricing method is clearly more appropriate. Lufkin has not shown that each of the three methods is inapplicable, nor has it shown that a more appropriate method ought to be utilized. [468 F. 2d at 808.]

From this language, we believe that the reversal of *Lufkin* is distinguishable. In the instant case, we are faced here with the task of approximating, as best we can, the arm's-length prices for Darvon and Darvon-N products in 1971 and 1972. The three preferred pricing methods detailed in the regulations are clearly inapplicable due to a lack of comparable or similar uncontrolled transactions. Petitioner's evidence amply demon-

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[83] The Court noted that, because the taxpayer did not have the benefit of the regulations under sec. 482 (adopted Apr. 15, 1968) for the tax years in issue (1961 and 1962), it did not attempt to consider the case within the confines of those regulations.

[84] The author states in Fuller, "Section 482 Revisited," 31 Tax L. Rev. 475, 513 (1976), with respect to this case, that the Service decided to prosecute an appeal in *Lufkin* apparently only after careful consideration was given to the profit split analysis of the opinion. As he explains in note 158:

> "The Service appealed the Tax Court's decision on October 20, 1971, but on November 9, 1971 the court granted the Service's motion to extend the time for transmission of the record to the Fifth Circuit to January 8, 1972 to give the Service time to determine whether the appeal should be further prosecuted. See Aland, Section 482: 1971 Version, 49 Taxes 815, 826 (1971). The Treasury Department was working at that time on a revised approach to intercompany pricing and it was understood by some tax practitioners that 'the Treasury [was] devoting its most intensive efforts' to developing an income spliting approach. See Hammer, Morrione & Ryan, Concepts and Techniques in Determining the Reasonableness of Intercompany Pricing Between United States Corporations and Their Overseas Subsidiaries, 30 N.Y.U. Inst. 1407, 1437–1438 (1972)."

strates that some fourth method not only is more appropriate, but is inescapable.

Petitioner's method of allocating income between itself and Lilly P.R. during 1972, although presented to us at trial and on brief as satisfying the arm's-length dealing test under the resale price method, was, in substance, based upon a profit split formula. By applying that formula to the amounts determined using petitioner's system of allocating expenses, petitioner derived its discount from net wholesale prices to be applied to Lilly P.R.'s sales to petitioner.

During 1972, petitioner's profit-split formula resulted in Lilly P.R. earning a manufacturing profit of 100 percent of its manufacturing costs (less operating expenses), plus its location savings from operating in Puerto Rico[85] and 60 percent of the combined net income attributable to the intangibles. Petitioner thereby earned a gross profit of 125 percent of its expenses related to the marketing of Darvon and Darvon-N products and the remaining 40 percent of the net income attributable to the intangible property.[86] While postponing for now the question of the appropriate intangible profit divisions, we note our acceptance of petitioner's use of a location savings. Respondent, in computing his allocations of income in both the notice of deficiency and the amended answer, allowed Lilly P.R. a location savings. Because petitioner has introduced no evidence showing that respondent's figures were erroneous, we will, accordingly, use those stated in the notice of deficiency.

We also approve of the 100-percent manufacturing profit allowed Lilly P.R. Respondent, in his notice of deficiency, constructed prices at which the Mayaguez facility would transfer bulk propoxyphene hydrochloride and napsylate chemicals to the Carolina pharmaceutical manufacturing plant. The excess of those prices over Mayaguez's actual costs was allowed as manufacturing profit; Carolina received a manufacturing profit of 25 percent of its costs. Respondent's amended answer eliminated the intra-company profit and

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[85] The location savings portion of the formula represented the reduced cost of operating in Puerto Rico as compared to the United States and was attributable primarily to lower labor rates and Lilly P.R.'s exemptions from Puerto Rican property and other nonincome taxes.

[86] The combined net income attributable to the intangibles (e.g. patents, manufacturing know-how, trademarks, tradenames, reputation, and goodwill) was calculated as the combined net profit excluding Lilly P.R.'s manufacturing profit and location savings, and petitioner's marketing profit. Petitioner owned the marketing intangibles, and was entitled to the income attributable thereto.

allowed Lilly P.R. only a manufacturing gross profit of 130 percent of the sum of Lilly P.R.'s manufacturing costs and the location savings. Respondent has the burden of proof with respect to his amended answer and did not introduce any evidence to show the reasonableness of his method. Accordingly, our options are limited to petitioner's formula or respondent's notice of deficiency method. Based on our judgment that the results of the two are substantially equivalent,[87] and because respondent has focused his concern on the income from the intangibles, we will use petitioner's manufacturing profit of 100 percent.

With respect to petitioner's marketing profit, we decline to use petitioner's profit split formula. Under that formula, petitioner would earn a marketing profit of 25 percent of its marketing expenses. Such a profit differs substantially from petitioner's initial pricing policy established in 1965 by the second Puerto Rican project team, which recommended that petitioner earn profits equal to 90 to 100 percent of its marketing expenses based upon an analysis of the operating income to operating expense ratios of Marion Laboratories, Inc., and petitioner's foreign affiliates. See pp. 1024–1025 *supra*. Were we to apply the 25-percent figure to petitioner's 1971 and 1972 taxable years, petitioner's marketing profit for each year would be approximately $2,455,000 and $3,154,000 respectively. Such a profit in our judgment is unreasonably low considering petitioner's extensive marketing operations and net sales of Darvon and Darvon-N products in excess of $55 million and $73 million during 1971 and 1972. Consequently, we believe that petitioner should earn a marketing profit of 100 percent (of its marketing expenses) as originally recommended by its own project team.[88]

As previously stated, petitioner's profit split formula was applied to the amounts determined on the basis of allocations of expenses made by petitioner relative to its Darvon and Darvon-N operations. See Combined Income Statements for

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[87] Lilly P.R.'s manufacturing profit for 1971 as computed using petitioner's formula would be $14,549,000 (100 percent of Lilly P.R.'s manufacturing costs less operating expenses—$9,821,000 (see p. 1163 *infra*) plus Lilly P.R.'s location savings allowed by respondent—$4,728,000); Lilly P.R.'s gross profit for 1971 per respondent's notice of deficiency was $13,671,275 (Mayaguez—$7,732,538 plus Carolina—$5,938,737).

[88] Generally, by increasing petitioner's marketing profits we are decreasing Lilly P.R.'s prices to petitioner for Darvon and Darvon-N products. See pp. 1078–1080 *supra*.

Darvon and Darvon-N Products at pages 1092–1093. Respondent alleges that certain of those allocations of expense items to income are erroneous and not in conformity with arm's-length dealings. We agree with respondent in principle but not as to specifics.

i. *Cost of Goods Sold*

The first category of expenses is the cost of goods sold. In 1971, petitioner's cost of goods sold for Darvon and Darvon-N products did not include any expenses of petitioner's ticket issuance department. However, petitioner's cost of goods sold for 1972 and 1973 included an increasing percentage of the expenses of petitioner's ticket issuance department.[89] The ticket issuance department retained, copied, and sent to Lilly P.R. the manufacturing work tickets needed for its manufacture of chemical and pharmaceutical products. Petitioner determined that, based on the ratio of the number of manufacturing tickets for Darvon and Darvon-N products issued to Lilly P.R. for a year to the total number of manufacturing tickets issued during that year, 5 percent ($15,000) of the total department expenses for 1972 and 7 percent ($22,000) of the total department expenses for 1973 should be charged to petitioner's cost of goods sold for Darvon and Darvon-N products for those respective years.

Petitioner's Darvon and Darvon-N cost of goods sold for 1971 did not include any portion of the expenses of petitioner's finished stock planning department. As with the ticket issuance department expenses, some expenses of petitioner's finished stock planning department were included in petitioner's cost of goods sold for 1972 and 1973. Petitioner based its allocation for those years on the ratio of the number of persons handling Puerto Rican source products to the total number of persons in the finished stock planning department. The expenses charged to cost of goods sold for 1972 and 1973 were 12 percent ($51,000) and 14 percent ($63,000), respectively, of the total expenses of the finished stock planning department for those years.

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[89] Because of the amounts of expenses of the ticket issuance and finished stock planning departments included in petitioner's cost of goods sold of Darvon and Darvon-N products increased from 1972 to 1973, we will consider this aspect of 1973 for the purpose of determining the expenses properly chargeable to cost of goods sold in 1971.

Section 1.482–2(b)(1), Income Tax Regs., provides that when one member of a group of controlled entities performs services for the benefit of another member without charge or for a charge which is less than arm's length, the District Director may make an appropriate allocation to reflect such an arm's-length charge. Section 1.482–2(b)(2)(i), Income Tax Regs., sets forth the "benefit test" relative to those services performed by one member of a controlled group for another. That section provides as follows:

> In general, allocations may be made if the service, at the time it was performed, related to the carrying on of an activity by another member or was intended to benefit another member, either in the member's overall operations or in its day-to-day activities * * *

In 1971, petitioner, through its ticket issuance and finished stock departments, provided Lilly P.R. with services for which it was not compensated. An adjustment must therefore be made to provide petitioner arm's-length compensation for those services. Exercising our best judgment, we allocate 3 percent of petitioner's 1971 ticket issuance department expenses ($285,000), or $8,550, and 10 percent of petitioner's 1971 finished stock planning department expenses ($438,000), or $43,800, from Lilly P.R. to petitioner.[20]

Petitioner charged for 1972 expenses stated above to cost of goods sold and did not bill Lilly P.R. or seek reimbursement for them on the ground that they were "stewardship" expenses. We believe that petitioner's characterization of the ticket issuance and finished stock planning functions as stewardship activities is in error and caused petitioner's 1972 cost of goods sold to be inflated.

Stewardship activities have been recognized both by the regulations and in case law as an exception to the rule that services between controlled entities must be reimbursed. Those activities are not defined by the section 482 regulations. However, the regulations under section 861 are somewhat analogous, and contain a specific cross-reference to the section

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[20] The amounts petitioner charged to cost of goods sold of Darvon and Darvon-N products for 1972 and 1973, respectively, were 5 percent and 7 percent of the total ticket issuance department expenses, and 12 percent and 14 percent of the finished stock planning department expenses. We believe that petitioner's methods of determining those charges are reasonable and appropriate. It follows that the allocations for 1971 should be 3 percent (ticket issuance) and 10 percent (stock planning) of the actual expenses of those departments.

482 regulations. Section 1.861–8(e)(4), Income Tax Regs., provides as follows:

> If a corporation renders services for the benefit of a related corporation and the corporation charges the related corporation for such services * * *, the deductions for expenses of the corporation attributable to the rendering of such services are considered definitely related to the amounts so charged and are to be allocated to such amounts. However, the regulations under section 482 (section 1.482–2(b)(2)(ii)) recognize a type of activity which is not considered to be for the benefit of a related corporation but is considered to constitute "stewardship" or "overseeing" functions undertaken for the corporation's own benefit as an investor in the related corporation, and therefore, a charge to the related corporation for such stewardship or overseeing functions is not provided for. Services undertaken by a corporation of a stewardship or overseeing character generally represent a duplication of services which the related corporation has independently performed for itself. * * *

Section 1.482–2(b)(2)(ii), Income Tax Regs., referenced in the preceding regulation, provides:

> Allocations will generally not be made if the service is merely a duplication of the service which the related party has independently performed or is performing for itself. In this connection, the ability to independently perform the service (in terms of qualification and ability of personnel) shall be taken into account. * * *

In a line of cases dealing with the deductibility of expenses claimed by one corporation when the expenses were incurred in connection with the activities of a related corporation, it has been held that amounts associated with day-to-day operations cannot be considered as stewardship expenses. See *Austin Co. v. Commissioner*, 71 T.C. 955 (1979); *Columbian Rope Co. v. Commissioner*, 42 T.C. 800 (1964). See also Feinschreiber, "Stewardship Expenses," 3 International Tax J. 344 (1977). In *Austin Co.*, the issue concerned whether or not the taxpayer was entitled to a deduction under section 162 for reimbursing a foreign subsidiary for foreign taxes it paid on salaries of loaned technical personnel. The taxpayer attempted to justify the deductibility of its payment of such taxes, claiming that it benefited by protecting its foreign investment and also by reducing its overhead burden of the salaried personnel. This Court responded to that claim as follows:

> Petitioner's argument that it loaned, on a full-time basis, supervisory and administrative personnel to safeguard its foreign investment simply does not

withstand analysis * * *. No doubt this relationship enhanced the successful operation of Mexicanos which benefited petitioner as its owner, but this type of indirect and incidental benefit is not enough to justify petitioner's deduction. *Columbian Rope Co. v. Commissioner*, *supra* at 815–816. Petitioner simply cannot claim as its own expense, amounts paid for activities that were concerned with the day-to-day operation of the subsidiary's business. *Young & Rubicam, Inc. v. United States*, [187 Ct. Cl. 635, 410 F.2d 1233 (1969)] *supra* at 1239. [71 T.C. at 967–968.]

Petitioner herein cannot claim as its own expenses amounts attributable to the ticket issuance and finished stock planning functions performed for Lilly P.R. The activities were not of an "overseeing" nature and were not carried out to benefit petitioner in its capacity as an investor in Lilly P.R. The ticket issuance and finished stock planning activities were necessary to and part of Lilly P.R.'s day-to-day manufacturing operations. As Dr. Frederic Lloyd, Vice President-Production, Operations Division of petitioner, testified with respect to the ticket issuance function, a "manufacturing ticket is the key to the whole technique of control of a manufacturing operation and the quality of the product that is produced" and "Some kind of a ticket kind of procedure is an FDA requirement." Dr. Lloyd described the function that produced those tickets as being "clerical" in nature. Moreover, the services performed by petitioner were not duplications of those independently performed by Lilly P.R. for itself.[91]

The ticket issuance and finished stock planning functions were not stewardship functions. Accordingly, the amounts petitioner charged to its cost of goods sold for Darvon and Darvon-N products during 1972 (and 1973, though we discuss that year separately) for those functions must be reallocated from petitioner to Lilly P.R.

ii. *Operating Expenses*

The next category we consider is operating expenses, which includes the expenses of general administration, selling, merchandising, shipping, samples, and research and development. Respondent attacks the manner in which petitioner allocates those expenses, alleging that petitioner's method does not reflect the actual expenses borne by the revenue to which the

[91] We have considered the fact that Lilly P.R. could have performed the ticket issuance function during the years in issue had it had the necessary copy machine, but find it of no importance. The day-to-day character of the function remains unchanged.

allocations are made. Respondent finds particular fault with petitioner's allocations of general administrative and research and development costs. We will discuss each of these in turn.

Petitioner's general administrative expenses were allocated on the basis of a percentage of the selling, merchandising, and shipping expenses which it determined were incurred relative to its marketing of Darvon and Darvon-N products. The percentage was determined by dividing the total general administrative expenses of petitioner's pharmaceutical division by its (1) manufacturing costs less material costs; (2) total research and development expenses, and (3) selling, merchandising, and shipping expenses. Respondent presented the testimony of Dr. James Wheeler, an expert accounting witness, to prove that the percentage factor resulted in unreasonably low allocations of general administrative expenses to petitioner's Darvon and Darvon-N products. Dr. Wheeler based his opinion on the fact that, in an industry like the pharmaceutical one, general and administrative expenses are closely related to the direct costs of materials. Petitioner, however, excluded materials cost from the denominator of its ratio, and used instead only labor costs and overhead, overhead already being an allocated figure. Dr. Wheeler also testified that the use of the research and development figure in the denominator of the administrative expense factor caused some portion of the administrative expenses to be allocated away to research and development expenses, but none of petitioner's general research and development expenses were allocated to any of the product lines.

Dr. Wheeler tested the allocations in question by comparing petitioner's and Lilly P.R.'s rates of return on employed assets, rates of return on net sales, and percentages of operating expenses to sales. While we agree with the logic and correctness of Dr. Wheeler's conclusions regarding the allocation factor, we will not substitute his results for petitioner's inasmuch as his calculations ignore any manufacturing return of Lilly P.R. which might be attributable to its intangible assets. We will, however, adjust petitioner's allocation factors to include the materials costs in the cost of goods sold figures.

Also, petitioner allowed Lilly P.R. the free use of its administrative manuals and paid the legal expenses connected with suits by persons claiming injuries caused by Darvon or

Darvon-N products (see pp. 1072–1073). The costs to petitioner were included in petitioner's general and administrative expenses. Petitioner has allocated its general and administrative expenses as a percentage of its Darvon and Darvon-N marketing expenses, a method which we understand to include only those expenses allocable to the burden and overhead of petitioner's Darvon and Darvon-N selling, merchandising, and shipping activities. To capture the expense of the manuals, legal fees, and all other nonmarketing general and administrative expenses, we must increase the allocation factor. Petitioner has introduced no evidence on this matter. Therefore, using our best judgment we have concluded that a 10-percent increase is appropriate. Accordingly, using petitioner's formula for allocation of general and administrative expenses, with modifications,[92] we have determined that petitioner's general and administrative expenses with respect to Darvon and Darvon-N products should be adjusted to $1,222,097 and $1,685,532 for 1971 and 1972, respectively.[93] Thus, petitioner must include an additional $17,920 and $155,178 as general

[92] Besides including material costs in petitioner's cost of goods sold and increasing the allocation factor by 10 percent, we are using only petitioner's pharmaceutical division research and development expenses, rather than the total research and development expenses used by petitioner.

[93] The amounts were calculated as follows (000's omitted):

$$\left[\left(\frac{\text{Total G \& A}^1}{\text{COGS}^2 + \text{R\&D}^3 + \text{Mrktg.}^4}\right) 100\%\right] \times \text{Mrktg. allocated to Darvon/Darvon-N}^5 = \text{Darvon/Darvon-N G\&A}$$

1971

$$\left[\left(\frac{31{,}740}{135{,}365 + 40{,}393 + 69{,}963}\right) 110\%\right] \times 8{,}601 = 1{,}222{,}097$$

1972

$$\left[\left(\frac{35{,}069}{135{,}781 + 45{,}397 + 68{,}994}\right) 110\%\right] \times 10{,}931 = 1{,}685{,}532$$

[1] General and administrative expenses of petitioner's pharmaceutical division, p. 1089.

[2] Cost of goods sold of petitioner's pharmaceutical division, p. 1089.

[3] Research and development expenses of petitioner's pharmaceutical division, p. 1063.

[4] Selling, merchandising, and shipping expenses of petitioner's pharmaceutical division, p. 1089.

[5] Selling, merchandising, and shipping expenses with respect to Darvon and Darvon-N products, pp. 1092–1093.

administrative expenses for the respective years 1971 and 1972.

The next types of expenses included in petitioner's operating expenses are selling, merchandising, and shipping, i.e., petitioner's marketing expenses. Respondent does not seriously challenge the allocation methods of those expenses, nor can we find any error in such methods. Petitioner's expert accounting witness, Howard L. Shearon, testified at length and in great detail concerning petitioner's allocation methods. We found him to be an impressive witness who explained the methodologies used in connection with the ascertainment of the marketing expense items, carefully, and in a readily comprehensible manner. We agree that those methodologies were reasonable, and make no allocations with respect thereto.

We next consider research and development expenses. Up to this point we have dealt with what are considered by accountants to be strictly operating costs. Accounting methodology is concerned with associating, or matching, expenses with the appropriate time period as well as with the appropriate income. Operating expenses relate to the current operating period and are those costs currently chargeable against the principal revenue sources. While Lilly P.R.'s payments for the expenses of the support research and development activities[94] carried out for it under the joint research agreement were currently chargeable against its sales income, research and development expenses ordinarily are not considered operating expenses, but are other current income deductions.[95] This is because, as petitioner's Controller, Richard A. Warne, testified, general research and development expenses do not apply to present operations or to any defined period, but apply only to future operations.

During the years in issue, Lilly P.R. was charged by petitioner for certain research and development expenses under the terms of the joint research agreement. Those

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[94] As discussed in our findings of fact, petitioner's research and development activities were categorized according to the nature of the work involved. The three categories were (1) general, involving the search for new pharmaceutical products; (2) defined, involving development of a specific new product; and (3) continuing or support, involving the ongoing research for, e.g., improved formulations or delivery systems of established products. The expenses allocated to Darvon and Darvon-N during the years in issue were primarily for support activities.

[95] See R. Wixon, W. Kell & N. Bedford, Accountants' Handbook 2-49—9-51 (5th ed. 1970); American Institute of Certified Public Accountants, Inc., 2 APB Accounting Principles, APB Opinion No. 9, at 6557, 6560-6561 (June 30, 1973).

expenses were for research and development activities carried out by petitioner that petitioner determined related specifically to Darvon and Darvon-N products. Similarly, petitioner recorded and allocated to its other product lines the research and development expenses it determined related specifically to those product lines. No allocation, however, was made of the general research and development expenses.[96] Those expenses were borne by petitioner's total revenues.

We have carefully considered the testimony of both parties' expert accounting witnesses. Petitioner's witnesses maintained that, because the general research and development expenses did not relate to any specific time period or pharmaceutical product, no allocation of those expenses to Darvon and Darvon-N products in 1971 and 1972 was necessary. Respondent and his experts believe that, given the research-intensive nature of the pharmaceutical business, no independent entity could fail to do otherwise. For the reasons discussed below, we agree with respondent.

Research and development is the lifeblood of the pharmaceutical industry. Pharmaceutical companies rely for their long-range survival on the research and development of new chemical products as well as on the maintenance and upgrading of their existing patents. The time and cost of inventing and developing new drugs and testing them in order to receive FDA approval to market them is a complex, risky,[97] and expensive[98] process. A pharmaceutical company must fund that process through the revenues of its successfully marketed products.

In this case, petitioner invented and developed two highly successful products. Petitioner transferred the patents and

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[96] Although the parties stipulated that 60 percent of petitioner's research and development expenses related to general (not defined or support) research and development activities, petitioner's expert accounting witness, Howard L. Shearon, testified that 80 percent of petitioner's research and development expenses were not allocated to particular products or product lines. Because petitioner has not proven that all the expenses connected with its provision to Lilly P.R. of FDA-related services, including, but not limited to, the maintenance of Darvon and Darvon-N NDAs, the retention and storage of lot samples, and the allowance of the right to refer to petitioner's NDAs in subsequent and supplemental NDAs, were allocated to and reimbursed by Lilly P.R., we will use the 80-percent figure as the amount of petitioner's unallocated research and development expenses.

[97] Only 1 in 8,000 new synthesized compounds is finally marketed as a new drug. Only 1 in 10 new drugs for which INDs are filed ever receives final FDA approval for marketing.

[98] Joint Exhibit 73-BT, titled "Research and Development Intensity in Pharmaceutical Industry—A Composite Profile of Six Major Companies," states that, for 1971, research and development expenses as a percentage of net income was 42.4 percent.

know-how for those products to Lilly P.R. in a section 351 exchange. Petitioner did not receive royalties, a lump-sum payment, or other arm's-length consideration to take the place of the prospective revenues those patents would have produced. Petitioner thus deprived itself of the means to carry on a portion of its general research and development activities, or at least, was forced to fund those activities with income that would otherwise have gone elsewhere (e.g., shareholders' dividends, capital investments). As respondent's expert accounting witness, Dr. James Wheeler, testified, using petitioners' allocation methods, were petitioner to transfer the patents and know-how for its nine most profitable products to a related entity for manufacture and sale of those products to petitioner, petitioner would not receive sufficient income from the marketing of such products to sustain its operations.

Dr. Wheeler stated, and we agree, that no independent company would market a product for an amount insufficient to cover its own ongoing expenses. Petitioner's research and development has contributed greatly to its success in the pharmaceutical industry, and is not a function that we believe petitioner would discontinue under any circumstances. Accordingly, some allocation of research and development expenses must be made. We conclude that $7,054,856 and $7,844,778 should be included in petitioner's operating expenses for 1971 and 1972, respectively, to cover a proportionate share of its general research and development expenses.[99]

Petitioner's remaining potential problem areas can be dealt with summarily. The technical assistance fees it billed to Lilly P.R. during the years in issue were determined according to the number of hours reported by petitioner's employees

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[99] The figures above were based upon the percentage of petitioner's sales of Darvon and Darvon-N products to petitioner's total pharmaceutical sales, and were calculated as follows:

Darvon/Darvon-N sales (from pp. 1092–1093) / total sales (from p. 1089)	×	80% pharm. R&D (from p. 1063)	=	Darvon and Darvon-N general R&D
1971				
73,861,799 / 238,321,035	×	.80 (40,393,000)	=	7,054,856
1972				
75,827,232 / 351,043,948	×	.80 (45,397,000)	=	7,844,778

multiplied by the technical assistance fee rates applicable to those employees, plus 5 percent of the hourly charge. The technical assistance fee rates were equal to the average hourly compensation costs, including benefits and employment taxes, for petitioner's employees. Petitioner also billed Lilly P.R. for traveling expenses and the standard charge for engineering services. The amounts billed represented all the technical assistance rendered to Lilly P.R. during 1971 and 1972, except for the ticket issuance and finished stock planning services mentioned previously. Accordingly, no allocation with respect to the technical assistance fees is warranted.

During the years 1971 and 1972, Lilly P.R. purchased 20 percent and 19 percent, respectively, of its raw materials from petitioner. Lilly P.R. also purchased some of its equipment and machine parts through petitioner during those years. In the case of raw materials, petitioner charged Lilly P.R. at its cost for manufactured items and at its materials cost for items purchased by it. In the case of the equipment and machine parts, petitioner accumulated all costs with respect to its purchase of an item under a job cost number; when the item was received by petitioner, it shipped the item to Lilly P.R. and invoiced Lilly P.R. for the total costs accumulated. We believe the amounts billed to Lilly P.R. were reasonable and represented all the costs associated with the supplying of the materials and equipment to Lilly P.R., except for the clerical costs of the actual billings themselves. Those costs, however, can be viewed as falling under the umbrella of general and administrative services, a portion of which has already been included in petitioner's operating costs relative to Darvon and Darvon-N products. We conclude no revision is necessary with respect to the clerical costs of the actual billings.

The fees associated with the joint research agreement covered the research and development activities performed by petitioner for Lilly P.R. but not billed to Lilly P.R. under the technical assistance agreement. Under the joint research agreement, Lilly P.R. was invoiced for and paid the costs of Darvon and Darvon-N research and development activities performed by petitioner. Such activities were classified as support work, and consisted of the expenses attributed by Lilly Research Laboratories' project accounting system to the research projects and clinical grants related to Darvon and

Darvon-N products. Any activities not related directly to a specific product and thereby slipping outside of petitioner's project development system were billed to general research. Inasmuch as we already have revised petitioner's Darvon and Darvon-N expenses to include a portion of such general research and development expenses, no allocation is necessary here.

iii. *Applicable Profit Split Percentage*

We turn now to the application of the profit split approach to the revised income and expense items of petitioner and Lilly P.R.[100] Petitioner has stated at various times throughout the

[100] A summary of such items, and their places in the financial statements, are set forth below:

1971

Financial statements Lilly P.R. (from p. 1096)		*With adjustments Lilly P.R.*		
Net sales	$55,573,774	Net sales	$55,573,774	
Cost of goods sold	12,754,744	Cost of goods sold	12,754,744	
Gross profit	42,819,030	Gross profit		$42,819,030
Operating expenses	2,881,214	Operating expenses	2,881,214	
Operating profit	39,937,816	Adjustments:		
		Ticket issuance	8,550	
		Finished stock planning	43,800	
				2,933,564
		Operating profit		39,885,466
Petitioner (from p. 1092)		*Petitioner*		
Net sales	$73,861,799	Net sales	$73,861,799	
Cost of goods sold	47,059,792	Cost of goods sold	47,059,792	
Gross profit	26,802,007	Gross profit		$26,802,007
Operating expenses	9,805,444	Operating expenses	9,805,444	
Operating profit	16,996,563	Adjustments:		
		General administration	17,920	
		Research & development	7,054,856	
				16,878,220
				9,923,787
		Other operating income:		
		Ticket issuance	8,550	
		Finished stock planning	43,800	
				52,350
		Operating profit		9,976,137

1972

Financial statements Lilly P.R. (from p. 1066)		*With adjustments Lilly P.R.*		
Net sales	$57,188,297	Net sales	$57,188,297	
Cost of goods sold	14,387,345	Cost of goods sold	14,387,345	
Gross profit	42,800,952	Gross profit		$42,800,952

trial and on brief that Lilly P.R.'s prices to it were based upon and satisfied a profit split approach. To support its claim, petitioner introduced testimony pertaining to the relative value of patents and trademarks, as well as the testimony of its pharmaceutical industry expert witness regarding the profit level at which an unrelated company would be willing to market Darvon and Darvon-N products.

Eugene L. Step, president of petitioner's pharmaceutical division and possessing an impressive background in the pharmaceutical industry, testified concerning the marketing efforts of petitioner. Mr. Step stated that he considered petitioner's marketing force to be the leader among the approximately 30 pharmaceutical manufacturers in the United States, but that petitioner's name, reputation, and sales force were no guarantees of promoting a successful product if the product could not "sell itself." Mr. Step stressed the quality of a product and the discerning nature of the health care professionals who prescribe that product as being the deciding factors in its success rather than a trademark. He testified that health care professionals knew a successful product such as Darvon by its generic name of propoxyphene hydrochloride, and that, had the Darvon trademark name been lost, the professionals would have been alerted to a new trademark by pharmacists and petitioner's marketing force and would have simply prescribed the product under its new

Operating expenses	$3,085,136	Operating expenses	$3,085,136	
Operating profit	39,715,816	Adjustments:		
		Ticket issuance	$15,000	
		Finished stock planning	51,000	
				$3,151,136
		Operating profit		39,649,816

Petitioner (from pp. 1092–1093)		*Petitioner*		
Net sales	$75,827,232	Net sales		$75,827,232
Cost of goods sold	46,686,723	Cost of goods sold	$46,686,723	
Gross profit	29,140,509	Adjustments:		
		Ticket issuance	(15,000)	
		Finished stock planning	(51,000)	
				46,620,723
		Gross profit		29,206,509
Operating expenses	12,461,454	Operating expenses	12,461,454	
Operating profit	16,679,055	Adjustments:		
		General administration	155,178	
		Research & development	7,844,778	
				20,461,410
		Operating profit		8,745,099

name. Thus, the Darvon and Darvon-N trademarks had relatively less value as opposed to the patents, which gave Lilly P.R. the exclusive right to manufacture propoxyphene products in the United States.

This concept of the patent value exceeding the value of the trademark was reiterated by Dr. Baumol, one of petitioner's expert economic witnesses. Dr. Baumol was very familiar with the pharmaceutical industry, and became involved in this case in 1971. Dr. Baumol viewed the trademark for a product as having a negligible value so long as the patent for that product was in effect. He testified that any successful marketing operation, given the opportunity to market a high sales volume pharmaceutical product, could have created an identical demand for the sale of "Carvon," or whatever they chose to call it, with only minor expenditures for the establishment of the new trademark. We find the testimony of Mr. Step and Dr. Baumol very convincing in support of the proper profit split between the manufacturing and marketing intangibles.

Petitioner also introduced the testimony of Lawrence C. Hoff, Executive Vice President, World Wide Pharmaceutical Operations, Upjohn Co. As a result of his employment with the Upjohn Co. and his involvement in industry associations, Mr. Hoff developed throughout a 30-year career an extensive knowledge of the manufacturing and marketing of pharmaceutical products in the United States. Accordingly, Mr. Hoff was qualified as an expert witness on the U.S. pharmaceutical industry. Prior to trial, Mr. Hoff reviewed the sales history of Darvon and Darvon-N products for the years 1958 through 1973, the distribution agreement between petitioner and Lilly P.R., and also the combined income statements for Darvon and Darvon-N products set out in this opinion at pages 1092 and 1093.

Mr. Hoff became familiar with propoxyphene products when petitioner introduced Darvon in the late 1950s. In his opinion, petitioner's Darvon and Darvon-N products filled a significant therapeutic need for a product providing relief from mild to moderate pain. During the 1950s, there was a large gap between the narcotics used to treat severe pain and the over-the-counter drugs such as aspirin used to treat mild pain. For that reason, Mr. Hoff believed petitioner's Darvon and Darvon-N products were well accepted by physicians and were important products in the pharmaceutical industry.

It was Mr. Hoff's opinion that a product line such as Darvon and Darvon-N would be of substantial value to any pharmaceutical company. Petitioner's propoxyphene product line was well respected by health care professionals in the United States; propoxyphene products were used by health care professionals ranging from the rural general practitioner to the most experienced urban neurosurgeon. Moreover, the marketing of prescription pharmaceutical products is a sample-oriented business and, under the terms of the distribution agreement, Lilly P.R. provided petitioner with samples free in 1971 and 1972 and at manufacturing cost in 1973. Mr. Hoff believed that the ability to provide large numbers of samples of Darvon and Darvon-N products to a broad range of health care professionals, who respected and were interested in those products, would be extremely valuable to any pharmaceutical company because it would provide additional access to the offices of health care professionals.[101]

Mr. Hoff was also of the opinion that the promotion of Darvon and Darvon-N products by sales representatives would consume a minimal amount of time of those representatives, because the products were "doorknob detail" products, i.e., the promotion of the products was sample oriented and health care professionals already were interested in those products.

Mr. Hoff believed that the distribution of Lilly P.R.'s propoxyphene products would provide a pharmaceutical company a substantial return on its marketing efforts at the transfer prices charged by Lilly P.R. during the years in issue. Mr. Hoff, however, based his belief upon the profits afforded petitioner according to the pro forma combined income statements for Darvon and Darvon-N products. Those statements, as we previously discussed, were incorrect in several respects concerning petitioner's allocation of expenses. Accordingly, our adjustment of those statements requires a correlative adjustment of petitioner's profits for 1971 and 1972.

Mr. Hoff, as well as Mr. Step and Dr. Baumol, testified to the minimal value of the trademark while the patent protection remained in effect. The three agreed on the quality of

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[101] Mr. Step agreed with this aspect of the marketing intangibles. While he was not sure whether good products create a good company, or vice versa, he was sure that a good product enhances the reputation of a company, and makes it easier for that company's sales representatives to get in to see a health care professional about the company's other products.

petitioner's marketing force, but emphasized the value that a product line such as the Darvon and Darvon-N product lines would have for the marketing force promoting it, especially, as Messrs. Hoff and Step noted, in terms of increased access for its sales representatives to the offices of health care professionals. The three witnesses believed that the prices petitioner paid Lilly P.R. for its propoxyphene products were arm's-length prices based upon the *profit* petitioner received on their resale. Under the pricing formula petitioner used in determining Lilly P.R.'s prices, that profit was approximately 40 percent of the net intangible income.

We concur with Mr. Hoff, Mr. Step, and Dr. Baumol that the propoxyphene patents had relatively greater value than the Darvon and Darvon-N trademarks. We note, however, that those witnesses did not give enough weight to goodwill and the value of the Lilly name. The witnesses also failed to consider the short life remaining on the propoxyphene patent in 1971 and 1972. We question their assumption that an unrelated marketing company would have paid the same prices as petitioner for the propoxyphene products, knowing it had at best 2 years in which to develop the market recognition for its trademark before the patent expired. Mr. Hoff, Mr. Step, and Dr. Baumol agreed that, after the patent's expiration, the trademark was the intangible with the greater value.

Petitioner has failed to prove what the arm's-length prices for Lilly P.R.'s products should be, and we must bear heavily against petitioner in our determination. Using our best judgment, we conclude that petitioner should receive 45 percent of the net intangible income as its income attributable to the marketing intangibles. Consequently, we allocate $11,317,000 and $12,547,000 from Lilly P.R. to petitioner for the years 1971 and 1972, respectively.[102]

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[102] The following figures are taken from the adjusted financial statements on pp. 1163 and 1164, and from the findings of fact at p. 1106. The allocated amounts are in addition to those allocated from Lilly P.R. to petitioner for ticket issuance and finished stock planning expenses, and are calculated as follows (000's omitted):

	1971
Lilly P.R.'s operating profit	$39,885
Petitioner's operating profit	9,976
Combined operating profit	49,861
Less:	
Manufacturing profit—100%	

2. *1973 Taxable Year*

Because of the expiration of the propoxyphene patent at the end of 1972 and the entry into the U.S. market of at least 24 pharmaceutical companies which sold propoxyphene hydrochloride products in 1973, petitioner contends that in 1973 the most appropriate method for ascertaining arms'-length prices for Lilly P.R.'s products is to look to the market prices for such products in uncontrolled sales. It is petitioner's position that Lilly P.R.'s prices satisfy the comparable uncontrolled price

Lilly P.R.'s COGs less operating expenses		$9,821	
Location savings (from notice of deficiency)		4,726	
Marketing profit—100% petitioner's marketing expenses		9,823	
Total profit excluding intangibles			$24,372
Profit due to intangibles			26,489
Division of intangible profit			$14,019
Manufacturing — 55% Lilly P.R.			11,470
Marketing — 45% Petitioner			
Lilly P.R.		*Petitioner*	
Allocated profit	$14,019	Allocated profit	11,470
Manufacturing profit	9,821	Marketing profit	9,823
Location savings	4,726		21,293
	28,566		
Actual profit	39,886	Actual profit	9,976
	(11,317)		11,317

1972

Lilly P.R.'s operating profit			$39,650
Petitioner's operating profit			8,745
Combined operating profit			48,395
Less:			
Manufacturing profit—100% Lilly P.R.'s COGs less operating expenses		$11,236	
Location savings (from notice of deficiency)		5,265	
Marketing profit—100% petitioner's marketing expenses		12,617	
Total profit excluding intangibles			29,118
Profit due to intangibles			19,277
Division of intangible profit			$10,602
Manufacturing — 55% Lilly P.R.			8,675
Marketing — 45% Petitioner			
Lilly P.R.		*Petitioner*	
Allocated profit	$10,602	Allocated profit	$8,675
Manufacturing profit	11,236	Marketing profit	12,617
Location savings	5,265		21,293
	27,103		
Actual profit	39,650	Actual profit	8,745
	(12,547)		12,547

method of section 1.482–2(e)(2), Income Tax Regs.[103] While respondent agrees that the comparable uncontrolled price method is available for 1973, he takes issue with petitioner's adjustments to third-party prices for propoxyphene hydrochloride products.

a. *Comparable Uncontrolled Price Method*

Under the comparable uncontrolled price method, "the arm's length price of a controlled sale is equal to the price paid in comparable uncontrolled sales, adjusted as provided in subsection (ii) of this subparagraph." Sec. 1.482–2(e)(2)(i), Income Tax Regs. Uncontrolled sales are defined as "sales in which the sellers and the buyers are not members of the same controlled group." Sec. 1.482–2(e)(2)(ii), Income Tax Regs. The section 482 regulations also determine the comparability of uncontrolled sales, as follows:

> Uncontrolled sales are considered comparable to controlled sales if the physical property and circumstances involved in the uncontrolled sales are identical to the physical property and circumstances involved in the controlled sales, or if such properties and circumstances are so nearly identical that any differences either have no effect on price, or such differences can be reflected by a reasonable number of adjustments to the price of uncontrolled sales. For this purpose, differences can be reflected by adjusting prices only where such differences have a definite and reasonably ascertainable effect on price. If the differences can be reflected by such adjustment, then the price of the uncontrolled sale as adjusted constitutes the comparable uncontrolled sale price. Some of the differences which may affect the price of property are differences in the quality of the product, terms of sale, intangible property associated with the sale, time of sale, and the level of the market and the geographic market in which the sale takes place. Whether and to what extent differences in the various properties and circumstances affect price, and whether differences render sales noncomparable, depends upon the particular circumstances and property involved. [Sec. 1.482–2(e)(2)(ii), Income Tax Regs.]

Thus, under the comparable uncontrolled price method of section 1.482–2(e)(2), Income Tax Regs., adjustments can be made to reflect differences between the controlled sale and the uncontrolled sale. The only guidance for those adjustments is contained in the regulations which state, in section 1.482–2(e)(2)(ii), Income Tax Regs., "differences can be reflect-

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[103] As stated previously, that method, when available, is the preferred approach to arm's-length pricing. Sec. 1.482–2(e)(1)(ii), Income Tax Regs.

ed by adjusting prices only where such differences have a definite and reasonably ascertainable effect on price."

During 1973, Lilly P.R. sold its Darvon and Darvon-N products to petitioner at prices equal to a 58-percent discount from petitioner's net wholesale prices for those products. The discount from net wholesale prices was increased from its previous 1972 level of 46 percent to reflect the expiration of the propoxyphene patent at the end of 1972.

Throughout the years in issue, Smith Kline & French Laboratories, Inc. (hereinafter SKF) marketed a line of branded prescription pharmaceutical products on which patent protection had expired called the SK line. In 1973, after the expiration of the propoxyphene patent, the SK line included two propoxyphene hydrochloride products: plain propoxyphene hydrochloride which was manufactured by SKF, and SK-65 Compound (propoxyphene hydrochloride with a combination of aspirin, phenacetin, and caffeine) which was manufactured for SKF by Milan Pharmaceuticals, Inc. (hereinafter Milan), of Morgantown, West Virginia. SK-65 Compound was competitive with petitioner's Darvon Compound-65 (PU 369).

During 1973, SKF purchased 47,399,654 filled SK-65 Compound capsules from Milan at a total invoice cost of $742,865. Milan's price to SKF for a bottle of 500 SK-65 Compound capsules was $7.55. Milan and SKF are unrelated. Petitioner contends that, if the Milan prices to SKF are properly adjusted to reflect the differences between those sales and sales by Lilly P.R. to petitioner, the Milan prices to SKF fully support Lilly P.R.'s pricing for 1973.[104]

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[104] Neither party places much emphasis on the determination of arm's-length prices for all of Lilly P.R.'s Darvon and Darvon-N products based upon the prices for plain propoxyphene hydrochloride and propoxyphene hydrochloride compound products marketed by SKF and others. The reason for this is contained in sec. 1.482-2(e)(1)(iv), Income Tax Regs.:

"(iv) The methods of determining arm's length prices described in this section are stated in terms of their application to individual sales of property. However, because of the possibility that a taxpayer may make controlled sales of many different products, or many separate sales of the same product, it may be impractical to analyze every sale for the purposes of determining the arm's length price. It is therefore permissible to determine or verify arm's length prices by applying the appropriate methods of pricing to product lines or other groupings where it is impractical to ascertain an arm's length price for each product or sale." * * *

Petitioner determined Lilly P.R.'s prices according to a standard discount from net wholesale prices, applied to both Darvon and Darvon-N products. If the prices charged petitioner by Lilly P.R. for its Darvon Compound-65 were arm's-length prices, it follows that the prices charged petitioner on Lilly P.R.'s other products likewise were arm's-length prices. This reasoning is particularly persuasive here, as Darvon Compound-65 accounted for 50.7 percent of petitioner's Darvon and Darvon-N sales in 1973. (See p. 1089.)

READEX FICHE

i. *Petitioner's Adjustments to Milan's Prices*

Petitioner's economic experts compared the $7.55 price SKF paid for its SK-65 Compound with the $12.17 price petitioner paid Lilly P.R. for its Darvon Compound-65.[105] The experts identified seven adjustments which they believed had to be made to the Milan price in order to make the transactions between Milan and SKF comparable to the sales by Lilly P.R. to petitioner.

The first adjustment identified by petitioner's experts related to the raw materials furnished to Milan by SKF. SKF supplied to Milan at no charge the empty capsules, package inserts, labels, and bottle caps used by Milan to make SK-65 Compound for SKF. Lilly P.R. manufactured its own empty capsules, but purchased from petitioner the package inserts, labels, and some bottle caps needed for its Darvon Compound-65.[106] Petitioner's experts concluded that Milan's price should be adjusted for this difference by adding the costs that Milan would have incurred if it had purchased those materials. The experts determined that that adjustment should be $0.85 per bottle, although petitioner introduced evidence at trial to show that the actual cost of those materials to Milan was $1.14 per bottle.

The second factor which petitioner's economic experts identified for adjustment was the difference in credit terms provided by Milan versus those provided by Lilly P.R. Milan's credit terms to SKF were a 1-percent discount for payment in 10 days and net in 30 days. Lilly P.R.'s terms to petitioner were net in 180 days, and petitioner, as a practice, took the full 180 days to pay. Petitioner's experts valued the differences in those credit terms using the interest costs that petitioner would have saved by receiving from Lilly P.R. what amounted to a 5-month interest-free loan of $12.17 (the 1973 transfer prices of a bottle of 500 Darvon Compound-65 capsules). That value was determined to be $0.40 at an interest rate of 8 percent.

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[105] Petitioner's net wholesale price for Darvon Compound-65 in 500-capsule bottles was $28.97 (see p. 1074). Petitioner's discount from net wholesale prices for 1973 was 58 percent (see p. 1075). Fifty-eight percent of $28.97 is $12.17.

[106] For materials manufactured by petitioner, Lilly P.R. paid petitioner its cost plus 100 percent; for materials purchased by petitioner, Lilly P.R. paid petitioner its cost (including packaging and handling).

The third significant difference identified by petitioner's experts between the Milan sales to SKF and the Lilly P.R. sales to petitioner was that Lilly P.R. provided a substantial quantity of samples to petitioner at cost during 1973. Milan charged SKF $14.50 per thousand bulk capsules used by SKF as samples, and $0.135 for a sample pack of four capsules. Petitioner's experts thus increased Milan's prices by $1.56 per bottle to reflect the additional value of providing samples on the terms and in the relative amount provided by Lilly P.R.

The fourth adjustment described by petitioner's experts involved equipment loaned by SKF to Milan at no cost. The equipment was used by Milan in the packaging of SK-65 Compound capsules in packages of four capsules. Because Lilly P.R. owned all the equipment it used to manufacture Darvon products, petitioner's experts believed that Milan's price should be adjusted to reflect that difference by adding to that price the rental value of the equipment loaned by SKF to Milan.

The fifth item of adjustment related to the quality control operations for Milan's products carried out by SKF both at Milan's plant and at SKF's facilities. Lilly P.R. carried out its own quality control operations in Puerto Rico and reimbursed petitioner for certain sample tests performed by it in Indianapolis. Petitioner's experts determined that the cost of SKF's quality control activities should be added to the Milan price, but were unable to quantify this cost.

The sixth difference identified by petitioner's experts was the difference in quality of the Milan product as opposed to that manufactured by Lilly P.R. The Darvon compound product manufactured by Lilly P.R. during the years 1971 through 1973 utilized the glutamic acid hydrochloride formulation to avoid both the misuse and odor problems associated with other formulations of those products. Lilly P.R. bore the cost of developing that formulation, which was a trade secret owned by Lilly P.R. In contrast, the SK-65 Compound sold by Milan to SKF contained a propoxyphene pellet and, therefore, was subject to misuse. Furthermore, SK-65 Compound had a slightly greater variability of active ingredient per capsule than the Darvon Compound-65 produced by Lilly P.R.

The final adjustment by petitioner's experts was made with respect to the continued existence of the napsylate patent. The

$12.17 transfer price of Darvon Compound-65 in 1973 was computed by a formula[107] that spread the value of Lilly P.R.'s napsylate patent over all the Darvon and Darvon-N products produced by Lilly P.R.[108] Thus, the $12.17 price in part reflected the value of the napsylate patent. The experts concluded that either the Milan price or the Lilly P.R. price should be adjusted for that factor in order to make the Milan price comparable to that of Lilly P.R.

On the basis of the foregoing, the adjustments to the Milan price made by petitioner's experts can be summarized as follows:

Milan price	$7.55
Adjustments	
a. Raw materials	0.85
b. Credit terms	0.40
c. Samples	1.56
d. Equipment	
e. Quality control	
f. Quality differences	
g. Darvon-N patent	
Items d—g (estimate)	[1]1.81
Adjusted Milan price	12.17

[1]Because Milan's actual cost for raw materials was $1.14, petitioner states that the aggregate adjustment for items d—g need only be $1.52.

Petitioner's experts concluded that, because the adjusted Milan price was roughly equivalent to the price petitioner paid Lilly P.R. for the same product, the prices petitioner paid Lilly P.R. during 1973 for Darvon Compound-65, as well as all the other prices petitioner paid Lilly P.R. during 1973 for Darvon and Darvon-N products, were arm's-length prices. Petitioner relies upon the conclusions of its expert witnesses to support its contention that Lilly P.R.'s 1973 prices satisfied the comparable uncontrolled sales method of section 1.482–2(e)(2), Income Tax Regs., and thus were arm's-length prices.

ii. *Respondent's Expert Economic Evidence*

Respondent argues that petitioner's 1973 prices were not at

[107]In recognition of the propoxyphene patent's expiration on Dec. 27, 1972, petitioner revised its pricing formula so that petitioner would receive 70 percent of the intangible income for its possession of the Darvon trademark and other marketing intangibles, and Lilly P.R. would receive the remaining 30 percent as income attributable to its manufacturing intangibles.

[108]See note 104.

arm's length based upon his review of comparable sales of generic propoxyphene hydrochloride products in 1973. Respondent's evidence compares prices that Milan, Zenith Laboratories, Inc., Rachelle Laboratories, Inc., and Caribe Chemical Co., Inc., charged for manufacturing propoxyphene hydrochloride products. Respondent's approach to specific price evidence also differs from petitioner's by rejecting any add-ons to the prices uncontrolled manufacturing companies charged for the same products manufactured by Lilly P.R., and by encompassing a broader spectrum of propoxyphene products.

Respondent's expert economic witness, Dr. William Comanor, utilized two methods to determine what he believed to be arm's-length prices for the years 1971 through 1973. Both methods involved comparing the activities of three unrelated pharmaceutical companies with those of Lilly P.R. While we already have discussed the inherent flaws in Dr. Comanor's report and testimony (i.e., no rate of return computed for intangible property), we will consider such evidence insofar as it relates to third-party prices of propoxyphene products.

Dr. Comanor's first method observed third-party prices for propoxyphene hydrochloride products, using a weighted average of the prices to determine the percent differential between those prices and the ones charged by Lilly P.R. His second method involved observations of the gross profit margins earned by three pharmaceutical companies, Milan, Rachelle Laboratories, Inc., and Zenith Laboratories, Inc. Dr. Comanor determined an average gross margin for all three companies and then compared such margins to those actually earned by Lilly P.R.

Rachelle Laboratories, Inc. (hereinafter Rachelle), is a subsidiary of the International Rectifier Corp. and is located in Long Beach, California. In 1973, Rachelle had in its pharmaceutical line a plain propoxyphene hydrochloride product and a propoxyphene hydrochloride compound. The propoxyphene hydrochloride, sold in 65 mg. capsules, was produced by Rachelle; the propoxyphene hydrochloride compound-65 capsules were purchased as finished products from Caribe Chemical Co., Inc. (hereinafter Caribe), of the Virgin Islands.

A large part of Dr. Comanor's information concerning the three pharmaceutical companies previously mentioned was

obtained through interviews conducted by Dr. Comanor with company officials. The information pertaining to Rachelle and Caribe was provided at trial by Rachelle's president, Dr. Melvin Hochberg.[109] Dr. Hochberg produced records and letters which showed that Caribe's 1973 prices for the propoxyphene hydrochloride compound-65 mg. in 500-capsule bottles was $6.50 per bottle.

Rachelle employed approximately 200 persons in its Long Beach facility during 1973. Only 29 of those employees were involved in sales and marketing. Rachelle's net sales were $11,228,000 in 1973; its sales of propoxyphene hydrochloride products were approximately $50,000 in fiscal year ending June 30, 1973, and approximately $60,000 in fiscal year ending June 30, 1974.

Zenith Laboratories, Inc. (hereinafter Zenith), is a manufacturer of generic pharmaceutical products with facilities in New Jersey and in the Virgin Islands. Zenith purchases rather than produces the basic chemical ingredients needed for its pharmaceutical manufacturing activities. During the early 1970's Zenith employed approximately 190 persons. Zenith does not promote its products directly to physicians. Zenith's net sales for 1973 were $11,593,000; there is no evidence in the record indicating what proportion of those sales were attributable to sales of generic propoxyphene hydrochloride products.

Smith Kline & French, or SKF, a leading pharmaceutical company, has already been discussed in pertinent part.

Respondent argues that the information relative to the above companies, and Dr. Comanor's conclusions based thereon, clearly show that Lilly P.R's 1973 prices to petitioner were greater than arm's length. Although we agree with Dr. Comanor's ultimate conclusion, we disagree with his methods. Dr. Comanor's approach to pricing failed to take into account the presence of any intangibles held by Lilly P.R., specifically, in 1973, the glutamic acid hydrochloride formulation, and the napsylate patent. Respondent argues that Dr. Comanor purposely was told to evaluate the pricing relationship between petitioner and Lilly P.R., with no instructions given as to the ownership of intangibles, so as to achieve a fresh and untainted view of the situation, as opposed to petitioner's experts who

[109] Dr. Comanor did not use the information with respect to Caribe in his reports.

from the start assumed the presence of intangibles. Such an argument is specious and completely ignores the ownership of the intangibles by Lilly P.R.

Moreover, the pricing data relied upon by Dr. Comanor are not supported by evidence in the record. The data were derived from interviews conducted by Dr. Comanor with company officials of Milan, Zenith, and Rachelle. The prices are not supported by a single document in the record in this case and constitute hearsay evidence. The data were also inconsistent with the actual sales data introduced by petitioner with respect to SKF's purchases from Milan. Finally, the record is completely devoid of any facts regarding the circumstances of the sales by the three companies that would allow comparability to be determined, other than with respect to SKF's purchases from Milan. Rachelle and Zenith employed far fewer persons than did petitioner and had substantially lower net sales. Rachelle in particular had sales of propoxyphene hydrochloride products of only $50,000 in fiscal year ending June 30, 1973, and $60,000 the next year, as opposed to petitioner's sales of Darvon and Darvon-N products in 1973 of approximately $70 million (see page 1093). Mr. Hochberg's testimony with respect to Rachelle thus does not support the use of its sales as comparables.

Dr. Comanor, on direct examination, was responsive to the questions advanced by respondent's counsel; however, on cross-examination he refused to answer many of the hypothetical questions asked by petitioner's attorneys, which questions, in the Court's opinion, were very reasonable under the circumstances. In short, the substance of his testimony fell apart on cross-examination. Accordingly, we have discounted much of Dr. Comanor's report and testimony.

iii. *Determination of Arm's-Length Price*

We turn now to petitioner's adjustments to Milan's price for SK-65 Compound. The underlying rationale of the increases made by petitioner's experts is that Milan enjoyed a more advantageous relationship with SKF than Lilly P.R. enjoyed with petitioner. In order to equalize the positions, and prices, of the two, petitioner's experts believed it was necessary to adjust the Milan price before comparing it to the Lilly P.R. price for similar products.

The first add-on identified by petitioner's experts relates to raw materials that SKF provided free to Milan but which Lilly P.R. purchased for itself. Petitioner's experts determined an add-on of $0.85, and petitioner introduced evidence showing that the actual cost to Milan was $1.14. Respondent takes issue with any add-on whatsoever. He argues that the amount of materials provided to Milan was not great,[110] and that petitioner's experts merely speculated that the same materials would still have been provided free to Milan if it had produced the same volume of propoxyphene hydrochloride products as did Lilly P.R.

Respondent also alleges that petitioner's experts failed to consider certain favorable circumstances that petitioner extended Lilly P.R. with respect to the same raw materials. Petitioner originally granted Lilly P.R. two licenses to U.S. patents, together with manufacturing know-how, so that Lilly P.R. could manufacture empty capsules. Petitioner provided packaging materials, bottles, and labels to Lilly P.R. at cost. In addition, petitioner designed and obtained all FDA approvals for labels and package inserts with respect to Lilly P.R.'s products. In contrast, the costs associated with Milan's obtaining FDA approval of its product, including the approval of labels and package inserts, were borne by Milan and not SKF.

We believe some adjustment is necessary for the raw materials provided Milan by SKF. The amount of materials provided may not have been large by petitioner's standards, but it apparently represented 100 percent of Milan's needs, and Milan benefited therefrom accordingly. Respondent censures petitioner's experts for a "highly speculative" assumption that Milan would still receive free materials from SKF were Milan to produce the same volume of products as petitioner. However, in comparing the prices it is impossible to neutralize completely the effect caused by the differences in size and sales of Milan and Lilly P.R. Whether Milan's terms and prices would or would not differ depending on an increased volume, the fact remains that Milan did receive free materials. We too would be speculating if we refused to adjust Milan's price upwards for this difference based upon a notion that it is normal for small volume manufacturers to receive

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[110] The total value of those raw materials was $39,435.

some raw materials free of charge from their purchasers. An adjustment is necessary, but not in the amount of $1.14, which was the actual cost of the materials provided Milan, or $0.85, the amount estimated by petitioner's experts. To reflect more accurately the cost of the materials at the volume of sales carried on by Lilly P.R., the adjustment should be Lilly P.R.'s own cost of purchasing the raw materials. During 1973, Lilly P.R. manufactured the empty capsules it used to make Darvon Compound-65. During that time, petitioner manufactured and sold billions of empty capsules to unrelated customers throughout the world at a price of $1.60 per thousand capsules. Lilly P.R. lost approximately 3 percent of its capsules in the filling and finishing of Darvon Compound-65. Thus, the market price for Lilly P.R.'s empty capsules was approximately $0.82 per bottle of 500 capsules. Lilly P.R.'s standard cost per bottle of 500 Darvon Compound-65 capsules for labels, package inserts, and bottle caps was approximately $0.04 in 1973. Accordingly, Milan's price should be increased by $0.86.

Respondent argues that the Milan price should be reduced to take into account the favorable conditions Lilly P.R. enjoyed over Milan, namely, the licenses to manufacture capsules, the packaging and other materials provided at cost, and petitioner's design of, and obtainment of, FDA approval for Lilly P.R.'s labels and package inserts. Respondent's argument with respect to empty capsules is without merit inasmuch as Lilly P.R. agreed under the license agreements to pay petitioner a royalty of 5 cents per 1,000 commercially acceptable empty capsules manufactured by Lilly P.R. and covered by either of the two U.S. patents owned by petitioner. Respondent has neither argued nor introduced any evidence to prove that such license agreements were not at arm's length. Accordingly, Lilly P.R.'s manufacture of empty capsules is not cause for a downward adjustment to Milan's price. As for respondent's position that an adjustment is necessitated by petitioner's providing certain raw materials to Lilly P.R. at cost, we already have compensated for this factor by adjusting Milan's price upward to reflect Lilly P.R.'s own cost per 500-capsule bottles of labels, package inserts, and bottle caps.

Respondent urges us to reduce Milan's price to reflect its costs associated with Milan's obtaining FDA approval of its product, labels, and package inserts. We addressed the ques-

tion of Lilly P.R.'s reimbursing petitioner for research and development expenses, of which FDA work is a part, at an earlier time. We concluded that it is inappropriate to charge Lilly P.R. now for research and development activities carried on by petitioner in the past. Research and development activities performed by petitioner in 1973 with respect to Darvon and Darvon-N products (i.e., support research) were charged to Lilly P.R. under the joint research agreement. Petitioner has not proven that those amounts included the costs associated with maintaining FDA approval for the products, storing samples, and with updating and securing approval for the labels, packaging, and package inserts for those products. However, because those costs would be included in petitioner's general research and development expenses, which we discuss at pages 1159–1161, and *infra* at pages 1185–1186, we make no adjustment at this time.

Respondent next alleges that the adjustment made by petitioner's experts for the difference in credit terms was erroneous because petitioner and Lilly P.R. were related entities attempting to allow petitioner the tax-free use of Lilly P.R. funds in the United States.[111] We agree with petitioner's experts that such an adjustment is appropriate. Indeed, the terms of sale is one of the factors specifically mentioned in the section 482 regulations as a cause for adjustment of the comparable uncontrolled price. Sec. 1.482-2(e)(2)(ii), Income Tax Regs. Milan required payment from SKF of the net price in 30 days while Lilly P.R.'s terms were net in 180 days. However, instead of an adjustment of $0.40, based upon the interest saved by petitioner upon a 5-month loan of $12.17 with interest at 8 percent, we conclude the adjustment should be calculated using an interest rate of 5 percent. See sec. 1.483–1(c)(2)(ii), Income Tax Regs. Such a calculation would yield a $0.25 adjustment, were we to work our way backwards from Lilly P.R.'s actual price as petitioner's experts did. Our task, however, is to work forward and adjust Milan's price of $7.55 to the price we believe Lilly P.R. would have charged to an unrelated pharmaceutical company. Using our best judgment, we conclude the adjustment for the difference in credit terms is $0.20.

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[111] Petitioner, in 1973, could not receive dividends from Lilly P.R. without substantial tax consequences.

The third item of adjustment deals with samples. Petitioner's experts adjusted Milan's price to reflect the value of the samples provided to petitioner at cost during 1973, as opposed to the normal bulk price SKF paid Milan for capsules it used as samples. Respondent argues that petitioner's experts erroneously adjusted for this difference, which was not based on an advantage SKF received due to its terms of sale with Milan, but rather on Lilly P.R.'s relationship with petitioner. Respondent also argues that, because both SKF and petitioner packaged the majority of capsules used as samples, no difference exists and hence no adjustment is necessary. We agree with respondent that the add-on determined by petitioner's experts is incorrect. The add-on of $1.56 was calculated using petitioner's cost of purchasing samples at Lilly P.R.'s transfer price of $12.17 per 500-capsule bottles rather than at cost. In other words, petitioner's experts again are working backwards from Lilly P.R.'s transfer price in order to arrive at the components making up the differences between Lilly P.R.'s and Milan's prices. That approach is in error.

If Milan were to sell bulk capsules for samples to SKF at its cost rather than at its normal trade prices, Milan indeed would realize less income for so doing. The difference in income, however, merely would be Milan's lost profit on the transactions. Consequently, an add-on in the amount of the profit lost is appropriate in the instant case. Milan's price for bulk capsules was $14.50 per thousand capsules. Lilly P.R.'s prices to petitioner for bulk products were "consistent with its prices to Petitioner for products in trade packages." (Petitioner's requested finding of fact number 389, n. 12.) Petitioner's cost for purchasing the capsules it used as samples was $1,872,896. From the above information, one cannot definitely ascertain the correct adjustment, although we believe some adjustment is necessary. Because petitioner's inexactitude is of its own making, we must bear heavily against it in making our adjustment. *Cohan v. Commissioner*, 39 F.2d 540, 544 (2d Cir. 1930). Keeping in mind that both petitioner and SKF performed most of their own sample packaging activity, for which, as respondent points out, no adjustment is necessary, we conclude that Milan's price should be adjusted upward by $0.50.

The final four differences identified by petitioner's experts were free equipment, quality control, quality difference, and the napsylate patent. Petitioner's experts were unable to quantify the values of these four factors, and so provided what they determined was a conservative adjustment of $1.81. The equipment was excess sample packaging equipment loaned by SKF to Milan free of charge during 1973. Respondent correctly argues that no adjustment should be made to the purchase price paid by SKF for this alleged advantage of Milan because no evidence was presented as to the value of the equipment. Petitioner's witness, Mr. Brian McLarnon, was Director of Corporate Facilities for SKF at the time of trial and manager of the SK line during 1971, 1972, and the first half of 1973. Mr. McLarnon testified that the sample packaging equipment provided to Milan was excess equipment not being used by SKF at that time. He stated that the equipment was relatively old and that he did not know its original cost. In light of the fact that the only equipment loaned to Milan was old surplus equipment used only for the packaging of samples, and because there was no testimony or other evidence in the record of the value of that equipment, we believe an adjustment to Milan's price for SKF's provision of equipment is inappropriate.

Petitioner's experts determined an add-on to Milan's price for the quality control activities performed by SKF. Because SKF had certain of its quality control personnel at Milan's facility during each of SKF's production runs of SK-65 Compound, the experts concluded that Milan's relationship with SKF was more favorable than that of Lilly P.R.'s with petitioner. Respondent states, however, and we agree, that that analysis overlooks the fact that Milan was still required to employ and utilize its own quality control personnel. Milan's quality control personnel performed all required FDA checks on the SK-65 Compound produced. After the first several production runs of the compound, SKF accepted Milan's quality control assay reports. SKF did not maintain any FDA required records for Milan; Milan maintained all of the required records relative to its production of SK-65 Compound.

We believe that SKF's quality control activities on behalf of Milan were duplicative at best and did not relieve Milan of any of the costs of providing its own quality control. Accordingly,

petitioner's add-on for the difference in quality control is without merit.

The sixth adjustment by petitioner's experts was made with respect to quality differences between the Darvon Compound-65 manufactured by Lilly P.R. and the SK-65 Compound manufactured by Milan. We believe petitioner's experts correctly determined that some add-on to Milan's price is necessary for these differences. The Darvon Compound-65 manufactured by Lilly P.R. during 1973 utilized the glutamic acid hydrochloride formulation to avoid both the misuse and odor problems associated with other formulations of those products. Lilly P.R. developed and owned the know-how relative to the glutamic acid hydrochloride process. Lilly Research Laboratories in 1973 had begun evaluating generic propoxyphene hydrochloride formulations that were in direct competition with petitioner's Darvon 65 mg. and Darvon Compound-65. The quality of the generic products was compared with that of petitioner's Darvon products by examining specifications such as (a) uniformity of drug content, (b) uniformity of weight, (c) decomposition of aspirin in compound products into acetic acid and salicylic acid, and (d) purity, i.e., presence of nonpropoxyphene chemicals generated by the chemical manufacturing process.

One of the products evaluated by Lilly Research Laboratories was the SK-65 Compound manufactured by Milan. Milan at that time utilized the encased propoxyphene hydrochloride pellet to prevent its interaction with the aspirin in the formulation. Lilly Research Laboratories identified two problems with that formulation. First, the pellet easily was removed from the capsule and therefore was subject to misuse. Second, x-ray examination of the capsules showed a greater variability of active ingredient per capsule than in Darvon Compound-65, as some SK-65 Compound capsules contained either two pellets or no pellet at all.

Petitioner has demonstrated to the Court's satisfaction that Darvon Compound-65 was a better product than SK-65 Compound. It has not, however, demonstrated what the adjustment to Milan's price should be for that difference. When petitioner was attempting to determine arm's-length prices for Lilly P.R.'s products for 1973, when the propoxyphene patent no longer would be in existence, petitioner valued the glutamic

acid hydrochloride formula as providing Lilly P.R. a 3-percent royalty. Because the Darvon Compound products using that formula represented approximately 65 percent or $54 million of petitioner's 1973 estimated sales of Darvon and Darvon-N products of $70 million, petitioner estimated that approximately $2 million of income was attributable to the glutamic acid hydrochloride formula. See p. 1079. Bearing this in mind, and in light of all other pertinent facts, we conclude that Milan's price should be increased by $0.21.

The seventh and final adjustment involves the value of the unexpired napsylate patent owned by Lilly P.R. Because Lilly P.R. calculated its transfer prices on the basis of a standard discount from net wholesale price, the retained value of Lilly P.R.'s napsylate patent was spread across Lilly P.R.'s entire Darvon and Darvon-N product lines. Petitioner's experts thus believed that some adjustment to Milan's price was necessary to reflect the ownership of that valuable patent by Lilly P.R. Working backwards from Lilly P.R.'s transfer price of $12,17, and taking into consideration the increases previously determined, petitioner's experts arrived at a total figure of $1.81 for the last four adjustments. We are provided with no breakdown of that estimated, lump-sum amount, and petitioner has compounded our dilemma further by stating on brief that, because Milan's actual raw materials cost was proven at trial to be $1.14 rather than $0.85, the aggregate adjustment for the final four items need only be $1.52.

As with the glutamic acid hydrochloride formula, petitioner considered the value of the napsylate patent when it was attempting to set Lilly P.R.'s prices for 1973. See p. 1080. Petitioner at that time concluded that a reasonable royalty on the napsylate patent would be $1.5 to $3 million of the estimated $30 million attributable to intangibles under petitioner's method of allocations. On projected sales of $70 million, with sales of napsylate products projected to be approximately 20 percent of total sales, the napsylate royalty then was approximately 10 to 20 percent of total propoxyphene sales. Petitioner's expert, Dr. Brozen, testified that the napsylate patent royalty could go as high as 30 percent. Because Darvon-N sales in 1973 actually were approximately 25 percent of total sales, these figures represent possible royalties of 2.5, 5, and 7.5 percent of all propoxyphene sales.

Petitioner argues that the 7.5 percent factor (multiplied against the net wholesale price for Darvon Compound-65 of $28.97) would yield an adjustment of $2.17, which alone was well in excess of the aggregate adjustments of $1.81 or $1.52 determined by its experts as being the add-on for all four of the final four differences. The smaller 2.5- and 5-percent factors stated above yield adjustments of $0.72 and $1.45, respectively, when applied against petitioner's net wholesale price of $28.97.

While petitioner's evidence as to the value of the napsylate patent was uncontroverted by respondent, and it is clear that some adjustment is necessary, we cannot accept the figures above. Dr. Brozen was one of petitioner's economic witnesses: he has not shown that he had the necessary expertise in the pharmaceutical industry to value the napsylate patent. Also, the figures are based upon petitioner's method of allocating expenses between it and Lilly P.R.

Additionally, respondent argues that petitioner's experts failed to consider some important differences between the petitioner-Lilly P.R. and SFK-Milan sales relationships which would reduce the Milan price to SFK. During 1973, SFK's market for Milan's SK-65 Compound was in the range of $1 million, while petitioner's purchases of Lilly P.R.'s products were in excess of $30 million. Respondent contends that basic economics would provide for an adjustment to the prices where, as here, one of the parties was a large volume purchaser; and that petitioner's experts failed to take into account that an arm's-length purchaser paying $30 million for products would demand a substantial quantity discount. Respondent also argues that Lilly P.R., as opposed to Milan, bore none of the risk associated with manufacturing propoxyphene hydrochloride compound. SKF made no guarantees in the event Milan could not manufacture the product economically or if SKF could not successfully market the product against petitioner and other competitions. On the other hand, respondent alleges that Lilly P.R. had a guaranteed market for its products, and that production levels were determined by petitioner and Lilly P.R. assumed no risk in manufacturing Darvon and Darvon-N products.

We agree with respondent that the above factors must be taken into account when determining the adjustment for the

napsylate patent. The levels of market were greatly different between Lilly P.R. and Milan, and such a difference clearly is contemplated by the section 482 regulations as being susceptible to evaluation and adjustment. Sec. 1.482–2(e)(2)(ii), Income Tax Regs. Although we would not characterize Lilly P.R.'s relationship with petitioner as being one in which Lilly P.R. had a guaranteed purchaser for its products, the fact remains that petitioner notified Lilly P.R. of its anticipated product needs and Lilly P.R.'s production planning personnel then determined Lilly P.R.'s production schedules and output based upon that information. The likelihood of Lilly P.R. producing products for which it had no purchaser (petitioner) at the time, thus was highly remote.

Finally, in our discussion of the years 1971 and 1972, we stated that petitioner improperly classified some expenses and failed entirely to include others (i.e., general research and development expenses) in its pro forma combined income statements for Darvon and Darvon-N products. Such treatment artificially inflated the income resulting from Lilly P.R.'s ownership of the manufacturing intangibles. Irrespective of the total lack of connection between sales dollars and dollars spent on research, in the "real world" a research-intensive company such as petitioner simply would not purchase for resale a product that did not allow a sufficient return to cover a proportionate share of its research expenses. In keeping with our earlier holding concerning petitioner's current general research and development expenses, some adjustment is necessary to reflect that portion of petitioner's general research and development activities the cost of which is borne by Darvon and Darvon-N revenues.

Respondent has proven that, in making our adjustment with respect to the value of Lilly P.R.'s napsylate patent, we must consider the additional factors of market level, risk, technical assistance, and research and development. However, he has offered no evidence or estimation of what the adjustment should be. That task is left to us. Using our best judgment, we conclude that Milan's price should be increased by $0.48.

The following is a summary of the Court's adjustments to Milan's price for the reasons and in the amounts set out above.

Milan price	$7.55
Adjustments	
a. Raw materials	0.86
b. Credit terms	0.20
c. Samples	0.50
d. Equipment	
e. Quality control	
f. Quality difference	0.21
g. Napsylate patent, market level, risk, technical assistance, and research and development	0.48
Adjusted Milan price	9.80

The Milan price, as adjusted, yields an arm's-length price of $9.80 for Darvon Compound-65 in 500 capsule bottles. Petitioner's net wholesale price for such product was $28.97. Accordingly, Lilly P.R.'s prices for Darvon and Darvon-N products are adjusted to petitioner's net wholesale price less a discount of 66 percent.[112]

In accordance with our earlier discussion and holding concerning the expenses of petitioner's ticket issuance and finished stock planning activities performed for Lilly P.R., we also allocate from Lilly P.R. to petitioner the amounts of $22,000 (ticket issuance) and $63,000 (finished stock planning) in 1973.

B. *Revenue Procedure 63–10*

1. *1971 and 1972 Taxable Years*

Petitioner argues in the alternative that its prices for 1971 and 1972 can be measured under section 4.03 and 4.04 of Rev. Proc. 63–10, 1963–1 C.B. 490 (based upon Technical Information Release (T.I.R.) 441, dated January 11, 1963), and that under either of those subsections Lilly P.R.'s prices to petitioner satisfy the arm's-length standard. Respondent argues that Rev. Proc. 63–10 is not applicable to a situation where the mainland affiliate has transferred intangibles to its island affiliate without receiving in exchange adequate compensation.

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[112] Computed as follows:

Net wholesale price - (net wholesale price × discount) = Lilly P.R.'s transfer price

28.97 - (28.97 ×) = 9.8 × = .66

Rev. Proc. 63–10 was issued prior to the promulgation of the 1968 section 482 regulations and set forth guidelines for the application of section 482 in cases involving U.S. companies with Puerto Rican manufacturing affiliates. Rev. Proc. 63–10 still may be used in such cases if the result is more favorable to the taxpayer than that obtained under the section 482 regulations. Rev. Proc. 68–22, sec. 4, 1968–1 C.B. 819, 821. Sections 4.03 and 4.04 of Rev. Proc. 63–10 provide in their entirety as follows:

> .03 All Income-Producing Intangibles Belong to the Island Affiliate.
>
> If all applicable intangibles are treated as belonging to the island affiliate, all of the income produced by the intangibles is allowed to the island affiliate. In this case, gross income of the island affiliate would be determined on the basis of a selling price equal to the highest price which a representative independent United States company comparable to the mainland affiliate would pay for the product involved. In principle, this price would approximate the final United States market price for the product less (a) the mainland affiliate's costs of distribution, (b) a reasonable margin of profit for distribution, and (c) all costs incident to transportation from the point of sale in Puerto Rico.
>
> .04 Some Income-Producing Intangibles Belong to the Island Affiliate.
>
> If some, but not all intangibles which are significant in a joint operation are treated as belonging to the island affiliate, it would be allowed a price, which assumed the ownership of no intangibles plus an amount representing an estimated payment by the mainland affiliate for those intangibles owned by the island affiliate. This amount would be based on evidence available regarding what an independent company would receive as royalties or fees or as an increased price in such circumstances.
>
> [1963–1 C.B. at 496–497.]

Respondent argues that Rev. Proc. 63–10 applies only to cases in which the island affiliate itself has developed an intangible, or where it has purchased an intangible for arm's-length consideration. As support for his argument, respondent cites section 1 of the revenue procedure, which section provides in relevant part:

> The guidelines concern what may be considered as the standard type of allocation problem that has arisen in these cases. They do not deal with *other* problems that may be involved in particular cases, including those which may be present in cases involving the transfer of income producing intangibles from the United States to an affiliate located in Puerto Rico. [1963–1 C.B. at 490; emphasis added.]

We believe that Rev. Proc. 63–10 is clear on its face and that it does apply to the situation at hand. Contrary to respondent's assertion, the quoted language does nothing more than restate the obvious—that Rev. Proc. 63–10 does not provide guidelines for problems other than section 482 problems that could be involved in cases in which intangibles are transferred to Puerto Rican affiliates. The principle nonsection 482 problem involved in such cases is the determination of whether or not the intangibles in fact have been transferred.

Our interpretation is supported by a realistic view of the legal and factual environment in which Rev. Proc. 63–10 applies. The tax incentives provided by the government of Puerto Rico generally apply only to income from manufacturing operations in Puerto Rico. A Puerto Rican affiliate can qualify for the tax incentives of section 931 only if it earns 80 percent or more of its gross income from sources within Puerto Rico and 50 percent or more of its gross income from the active conduct of a trade or business in Puerto Rico. To qualify for those tax incentives, taxpayers must conduct their Puerto Rican operation according to certain well-defined patterns. Generally, mainland affiliates organize new wholly owned domestic subsidiaries to manufacture products in Puerto Rico, with the marketing and distribution functions retained and performed by the mainland affiliate. Moreover, except in unusual cases, any significant intangibles related to products manufactured by the Puerto Rican affiliate are first developed or acquired by the mainland affiliate.

In this context, the only realistic cases in which the Puerto Rican affiliate can own significant intangibles are those in which the intangibles have been transferred to the Puerto Rican affiliate from its mainland affiliate. If sections 4.03 and 4.04 of Rev. Proc. 63–10 do not apply to intangibles transferred to Puerto Rican affiliates, it is difficult to conceive of a case in which they would apply. Our interpretation of the language quoted by respondent is buttressed by section 4 of Rev. Proc. 63–10, entitled "Application of Section 482 in Cases Involving Intangibles." Subsection 4.01 states as follows:

> Not infrequently, the return attributable to intangibles is substantial. Therefore, in cases where significant income-producing intangibles are present the determination whether they belong to the island affiliate or the

mainland affiliate is important in the proper application of section 482 of the Code.

* * * * * * *

It is a question to be decided under the facts and circumstances of a particular case (a) whether significant intangibles are present, and (b) if significant intangibles are present, whether they belong to the mainland or the island affiliate.

[1963–1 C.B. 496.]

Furthermore, on January 15, 1963, 4 days after the issuance of T.I.R. 441, the Service issued Manual Supplement 42G–86, which provided instructions to Service personnel for applying the guidelines of T.I.R. 441. Section 4.02 of Manual Supplement 42G–86, entitled "Determination of the Party to Whom Intangibles Belong," provided as follows:

It is a question to be decided under the facts and circumstances of a particular case (a) whether significant intangibles are present and (b) if significant intangibles are present, whether they belong to the mainland or to the island affiliate.

* * * * * * *

As to other intangibles, such as patents, trademarks, trade names, etc., originally developed or owned by the mainland affiliate, an examination must be made to determine whether there is evidence that they have been transferred to the island affiliate. Taxpayers may claim that there has been a sale at a fair market price or a tax-free transfer under section 351, with section 367 clearance if the island affiliate is a foreign corporation rather than a section 931 domestic corporation.

Examination may show that there is in fact no substantial evidence that intangibles have been transferred or may show that the island affiliate has merely been permitted to use the mainland affiliate's intangibles as, for example, by manufacturing patented products and affixing to them the mainland affiliate's trademark. The lack of formal documents transferring the intangibles, continued use of the intangibles by the mainland affiliate in its own operations, and the retention by the mainland affiliate of protective and exploitative activities related to the intangibles, such as the conduct of infringement proceedings and supervision of licensing programs, would indicate that the intangibles have not, in substance, been transferred to the island affiliate and are still owned by the mainland affiliate.

Manual Supplement 42G–166, which was issued on April 8, 1968, was intended to supplement the provisions of Manual Supplement 42G–86. Section 5 of Manual Supplement 42G–166 provided that "the Service will continue to apply the

guidelines of Manual Supplement 42G–86." Section 5.03(8) of Manual Supplement 42G–166 provided in pertinent part as follows:

> In final analysis, however, as Section 4.02 of Manual Supplement 42G–86 points out, "It is a question to be decided under the facts and circumstances of a particular case (a) whether significant [income-producing] intangibles are present and (b) if significant intangibles are present, whether they belong to the mainland or to the island affiliate."

It thus is clear that Rev. Proc. 63–10 applies to the case in which the Puerto Rican subsidiary owns intangibles transferred to it by the U.S. parent. Petitioner argues that section 4.03 provides a resale-price method by which an arm's-length price can be determined. Without addressing any of petitioner's other contentions, we conclude that section 4.03 is not applicable to petitioner's case. Petitioner transferred to Lilly P.R. only the manufacturing intangibles; it retained and used the marketing intangibles associated with its sales of Darvon and Darvon-N products. Petitioner has made no claim otherwise. The value of its marketing intangibles was not an insubstantial amount, and we held that petitioner earned 45 percent of the net income attributable to intangibles through its promotion and sales of the trademarked Darvon and Darvon-N product line.

In short, because petitioner continued to own the marketing intangibles throughout the years in issue, Lilly P.R. did not own all of the income-producing intangibles as required by section 4.03 of Rev. Proc. 63–10. This result is contemplated in section 4.01, which provides as follows:

> It may be expected that as to certain intangibles no supportable contention could be made that they belong to the island affiliate. For example, if the mainland affiliate acts as the marketing and servicing organization for products produced by the island affiliate, any market position, consumer acceptance, or similar factors of good will attributable to the distribution and product servicing activities in the United States do not, as a matter of substance, belong to the island affiliate.

Consequently, section 4.03 is unavailable for our purposes herein. Section 4.04, however, provides guidelines for a case such as this, where "some, but not all intangibles which are significant in a joint operation are treated as belonging to the island affiliate." The guidelines are extremely brief and

basically provide that the island affiliate is to receive a price for its products as if it owned no intangibles, plus an amount representing an estimated payment from the mainland affiliate for the use of the intangibles owned by the island affiliate. This method is similar to the cost plus method of the regulations under section 482. We previously rejected the use of that method for 1971 and 1972 due to the lack of evidence with respect to unrelated companies and estimated royalty values. On the facts of this case, we conclude the method provided by Rev. Proc. 63–10, sec. 4.04, would not result in either a more accurate or more favorable estimate of Lilly P.R.'s arm's-length prices than the profit split approach we used under the section 482 regulations. We thus decline to apply it.

2. *1973 Taxable Year*

Petitioner argues in the alternative that Lilly P.R.'s prices satisfy the independent prices for similar products method under section 3.02(2) of Rev. Proc. 63–10, 1963–1 C.B. 490, 493. That section provides as follows:

> 2. Independent Prices for Similar Products.—The problem of applying section 482 of the Code is more difficult as a practical matter when directly applicable independent prices are not available. However, when a product manufactured in Puerto Rico and sold only to a mainland affiliate differs only slightly from other products bought and sold by independent firms, an arm's length price for the island affiliate may be determined by adjusting these independent prices to take account of such minor differences as are present.

Rev. Proc. 63–10 thus provides for adjustments to the independent prices just as section 1.482–2(e)(2) of the regulations does. Accordingly, our adjustments, adjusted price, and discount from petitioner's net wholesale prices would be the same under Rev. Proc. 63–10.

To reflect the foregoing,

Decision will be entered under Rule 155.

LOUIS A. AND ALICE A. WEIGL, ET AL.,[1] PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 1707–73, 1709–73, 1726–73, 1817–73, 1827–73, 3430–73, 3431–73, 953–74, 8098–76. Filed May 30, 1985.

In 1965 through 1967, H.L. Federman & Co. underwrote the issuance of securities for certain companies for which it received commissions ranging from $13,624 to $75,000. At the time of each of the underwritings, H.L. Federman & Co. also received nonqualified options or warrants to purchase stock or other securities of the companies whose securities it was underwriting. The warrants were not traded on an established securities market. They were subject to various restrictions on transferability and generally were not exercisable for a certain period of time. Sometime after H.L. Federman & Co. acquired the warrants, it assigned most of them to its shareholders.

In 1968 H.L. Federman transferred his interest in some of the warrants to a foreign situs trust, but he retained significant control over the trust property.

Held, H.L. Federman & Co. received the warrants as compensation for underwriting services rendered. *Held, further*, the validity of sec. 1.61–15(b) and sec. 1.421–6, Income Tax Regs., is upheld insofar as those regulations, for the years involved herein, provided rules for the valuation of warrants received by underwriters for services rendered.

Held, further, the transfer to the shareholders of the warrants constituted a dividend, taxable to the shareholders at the time a fair market value for the warrants can be determined.

Held, further, the transfer by H.L. Federman of warrants to a foreign situs trust constituted a transfer with a retained interest in the ownership and beneficial enjoyment of the warrants so that the income from the trust is taxable to H.L. Federman under the grantor trust rules of the Internal Revenue Code of 1954, as amended.

Burton W. Kanter, Harold J. Lipstiz, and *Charles H. Winkler*, for the petitioners in docket Nos. 1707–73, 1709–73, 1726–73, 1817–73, 1827–73, 3430–73, 3431–73, and 8098–76.

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[1] Cases of the following petitioners are consolidated herewith for trial, briefing, and opinion: Joseph and Beatrice E. Mathes, docket No. 1709–73; Walter C. and Alice C. Crawford, docket No. 1726–73; H.L. Federman & Co., Inc., docket No. 1817–73; Hyman L. Federman and Sylvia Federman, docket No. 1827–73; Morris and Ann Leverton, docket No. 3430–73; Morris and Ann Leverton, docket No. 3431–73; Lawrence Eisele and Alma Eisele, docket No. 953–74; and Hyman L. Federman and Sylvia Federman, docket No. 8098–76.

Louis Sternbach, for the petitioners in docket No. 953–74.
Judy Jacobs, for the respondent.

SWIFT, *Judge**: Respondent determined deficiencies in and additions to petitioners' Federal income tax liabilities as follows:

	Docket No.	Year	Deficiency	Sec. 6653(a)[2] addition to tax
Louis A. Weigl and Alice A. Weigl	1707–73	1967	$178.18	- - -
		1968	1,141.56	- - -
Joseph Mathes and Beatrice E. Mathes	1709–73	1967	177.13	- - -
		1968	1,645.06	- - -
Walter C. Crawford and Alice C. Crawford	1726–73	1967	2,896.81	- - -
H.L. Federman & Co., Inc.	1817–73	1966	- - -	- - -
		1967	- - -	- - -
		1968	1,445,483.79	- - -
Hyman L. Federman and Sylvia Federman	1827–73	1965	163,241.88	$8,162.09
		1966	2,272.59	113.63
		1967	100,889.44	- - -
		1968	637,530.87	- - -
	8098–76	1969	98,643.98	- - -
Morris Leverton and Ann Leverton	3430–73	1967	103,842.37	- - -
	3431–73	1968	90,230.97	- - -
		1969	- - -	- - -
Lawrence Eisele and Alma Eisele	953–74	1969	25,815.83	- - -

The issues for decision are: (1) Whether the warrants were received by H.L. Federman & Co. (hereinafter Federman Inc.) in its own right or as agent and nominee for its shareholders; (2) whether the warrants were received by Federman Inc. solely as an investment in exchange for the purchase price thereof and not as additional compensation for underwriting

*By order of the Chief Judge, these cases were reassigned from Judge William M. Fay to Judge Stephen J. Swift.

[2]Unless otherwise provided, all section references are to the Internal Revenue Code of 1954 as in effect during the years in issue.

services rendered; (3) if the warrants were received by Federman Inc. as compensation, when Federman Inc. must recognize and determine the amount of compensation with respect thereto; (4) whether the assignment by Federman Inc. of the warrants to its shareholders constituted the distribution of a dividend to the shareholders; (5) if so, when the shareholders must recognize and determine the amount of dividend income and the amount thereof; and (6) whether petitioner H.L. Federman is taxable on the income of a foreign situs trust under the grantor trust rules.

Questions regarding the valuation of the warrants involved herein have not yet been tried or briefed. If we conclude that the fair market value of any of the relevant securities must be determined, an additional trial session will be held for that purpose, unless a settlement is reached by the parties with regard to the valuation issues.

For clarity, we will first set out general findings of fact that pertain to the background of the issues to be decided. The general findings of fact will be followed by our separate findings of fact and our opinion as to each separate issue.

FINDINGS OF FACT

General Findings

Some of the facts have been stipulated and are so found.

Federman Inc. had its principal place of business in New York City when its petition was filed herein. Petitioners Lawrence and Alma Eisele resided in New Jersey when they filed their petition herein. Petitioners Morris and Ann Leverton resided in Switzerland when they filed their petitions herein. All other petitioners resided in the State of New York when they filed their petitions herein.

At all relevant times, Federman Inc. was a Delaware corporation principally engaged in the business of underwriting security issues. It was a member of both the New York and American Stock Exchanges and was subject to the rules and regulations of the Securities and Exchange Commission (SEC) and the National Association of Securities Dealers (NASD). The individual petitioners herein, H.L. Federman, Louis A. Weigl (Weigl), Joseph Mathes (Mathes), Morris Leverton (Leverton), Walter C. Crawford (Crawford), and Lawrence Eisele (Eisele), were shareholders of Federman Inc. and, with the exception of

Leverton, were also employees of Federman Inc. More specifically, during the years at issue, the stock of Federman Inc. was owned as follows:

Stockholder	*Date acquired*	*Date sold or retired*	*Type of stock*	*Number of shares*
R. Mittman	5/15/63	- - -	Nonvoting preferred (NVP)	5
L. Barber	6/15/63	5/10/66	NVP	5
W. Crawford	6/15/63	3/19/65	Common	25
H.L. Federman	6/15/63	- - -	Common	[3]140/171.1
I. Bloomberg	5/28/64	6/30/66	NVP	10
H. Herrman	5/28/64	6/30/66	Common	85
H. Moore	5/28/64	1966	Common	5
L. Eisele	5/28/64	6/30/66	Common	20
M. Leverton	1/11/66	6/30/67	NVP	[4]20
H. Seigl	2/11/66	4/19/66	NVP	5
P. Karp	3/21/66	- - -	NVP	98.05
S. Fink	4/20/66	- - -	Common	15
J. Daly	6/20/66	- - -	Common	3.34
L. Weigl	6/27/66	- - -	Common	2.75
J. Mathes	6/30/66	- - -	Common	2.75
G. Feldhamer	8/31/68	- - -	Common	14.63
D. Miller	1/02/68	- - -	NVP	20
N. Miller	2/09/68	- - -	NVP	5
S. Gass	4/04/68	- - -	NVP	20
L. Reich	4/24/68	- - -	NVP	10
M. Rosen	5/19/68	- - -	NVP	20
R. Mittman	5/20/68	- - -	NVP	15
E. Silverston	8/08/68	- - -	NVP	20
S. Silverston	8/08/68	- - -	NVP	10
A. Silverston	8/21/68	- - -	NVP	10
S. Federman	8/30/68	- - -	NVP	10

During the years involved herein Federman Inc. was a Wall Street Securities firm that specialized in underwriting stock and debentures issued by small, developing, high-technology companies. In connection with a particular security issue, Federman Inc. either acted as a single underwriter or as a member of a syndicate of underwriters. With respect to the particular stock and debentures involved herein, a syndicate underwrote the securities, but in each underwriting Federman Inc. was the manager of the underwriting or one of the lead

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[3]Federman owned 140 shares until Sept. 30, 1966, and 171.1 shares thereafter.
[4]Leverton acquired 15 shares on Jan. 11, 1966, and 5 shares on Apr. 19, 1966.

underwriters. NASD rules limited the underwriters' compensation, including reimbursement for expenses and legal fees, to 15-percent of the gross proceeds of an underwriting. SEC rules required a full disclosure of the underwriters' compensation but did not impose any limit on it, nor did the NASD rules preclude the grant to the underwriters of stock options or warrants in the securities of the company whose securities were being underwritten.

It is in the context of the underwritings of four of these companies (namely, Vernitron Corp., National Patent Development Corp., Scientific Control Corp., and DPA, Inc.) that the issues in this case arise.

CAPACITY IN WHICH FEDERMAN INC. RECEIVED THE WARRANTS

Vernitron Corp. Warrants

In July of 1966, Federman Inc. served as one of the lead underwriters in connection with a public offering by Vernitron Corp. (Vernitron) of 6½-percent convertible subordinated debentures in the principal amount of $1,500,000. Federman Inc. received from Vernitron a commission of $75,000 and reimbursement for expenses of $10,000 in connection with the underwriting.

In addition, the prospectus issued on July 8, 1966, in connection with that offering stated that Vernitron, for a total price of $125, would transfer to Federman Inc. for its investment account, warrants entitling Federman Inc., over the course of 5 years, to purchase at $11.50 per share, 12,500 shares of the common stock of Vernitron. The prospectus also stated that any gain realized by Federman Inc. on the receipt or exercise of the warrants would be treated as additional underwriting compensation for purposes of the Securities Act of 1933.

Substantial underwriting services were performed by Federman Inc. in connection with the issuance of the Vernitron convertible debentures, and on July 15, 1966, Federman Inc., pursuant to the underwriting agreement, received from Vernitron the 12,500 warrants,[5] and Federman Inc. paid to Verni-

[5] Pursuant to antidilution provisions, the number of the Vernitron warrants was subsequently increased to 13,128.

tron the $125. The letter from Vernitron transmitting the warrants to Federman Inc. stated that the warrants were granted to Federman Inc., individually, not as a representative or agent of any investors. The Vernitron warrants were not exercisable by Federman Inc. until July 15, 1967, and they expired on July 14, 1971. On July 15, 1966, the Vernitron common stock traded on the American Stock Exchange (ASE) at an average price of $8.625 per share. The Vernitron warrants received by Federman Inc. on July 15, 1966, were not registered with the SEC and thus were not freely transferable.

National Patent Development Corp. Warrants

In February of 1966, Federman Inc. underwrote the issuance by National Patent Development Corp. (NPDC) of $600,000 principal amount, 6-percent notes and of warrants to acquire 60,000 shares of NPDC common stock. Federman Inc. received from NPDC a commission of $25,000 in connection with the underwriting. In addition, the underwriting agreement, dated February 4, 1966, between Federman Inc. and NPDC stated that "as compensation for services hereunder," Federman Inc. also was to receive warrants to acquire 15,000 shares of NPDC common stock.

The underwriting services were performed by Federman Inc. in connection with the issuance of the NPDC notes and warrants, and on February 4, 1966, pursuant to the underwriting agreement, Federman Inc. received from NPDC warrants to purchase 18,163[6] shares of NPDC common stock at $7.50 per share. On June 30, 1966, Federman Inc. received from NPDC additional warrants to purchase and additional 150 shares of NPDC common stock at the same price. An S-1 registration statement filed by NPDC with the SEC in 1968 and a prospectus published by NPDC in 1968 stated that the NPDC warrants were being granted to Federman Inc. as "a portion of the fees in connection with placement of the [$600,000] promissory notes."

The NPDC warrants received by Federman Inc. were not exercisable until August 4, 1967, and they expired on Febru-

[6]No explanation is found in the record as to why or how the number of NPDC shares which Federman Inc. was entitled to receive under the warrants was increased from 15,000 shares to 18,163 shares.

ary 1, 1971. On February 4, 1966, on the over-the-counter market, the mean of the bid and asked price per common share of NPDC stock was $22.37. The NPDC warrants received by Federman Inc. were not registered with the SEC and thus were not freely transferable.

Scientific Control Corp. Warrants

In March of 1967, Federman Inc. underwrote the issuance by Scientific Control Corp. (SCC) of 6¾-percent convertible subordinated debentures in the principal amount of $750,000. Federman Inc. received from SCC a commission of $37,500 and reimbursement for expenses of $5,000 in connection with the underwriting.

In addition, the underwriting agreement, dated February 22, 1967, between Federman Inc. and SCC stated that Federman Inc. also would receive from SCC, as a condition of the underwriting services to be performed, a warrant to purchase 25,000 shares of SCC common stock as further compensation for the underwriting services to be rendered by Federman Inc. The underwriting agreement expressly provided that Federman Inc. would receive the SCC warrants "at the closing as an investment for [its] own account" and further that any shares acquired upon exercise of the warrant would be acquired "as an investment for [its] own account."

The underwriting services were performed and, pursuant to the underwriting agreement, on March 13, 1967, Federman Inc. received from SCC a warrant entitling it to purchase 25,000 shares of the common stock of SCC. The warrant was exercisable from April 1, 1967, through March 14, 1968, at $1.25 per share ($2.50 per share after a reverse stock split) and from March 15, 1968, through March 14, 1969, at $1.375 per share ($2.75 per share after a reverse stock split).

The written warrant specified that the warrant was nontransferable by Federman Inc. except "to a successor to Federman Inc. in a merger or consolidation, or to a purchaser of substantially all of the assets of Federman Inc., or to one or more stockholders of Federman Inc. in the event of its dissolution." Federman Inc. paid $2,500 to SCC in connection with receipt of the SCC stock warrant.

Also, in connection with the underwriting of the SCC convertible debentures, on March 31, 1967, Federman Inc.

received from SCC a warrant to purchase an SCC subordinated convertible debenture in the principal amount of $250,000. Federman Inc. paid $9,111 for the SCC convertible debenture warrant. The debenture warrant was exercisable from March 31, 1967, until January 15, 1968, and was convertible into 200,000 shares of SCC common stock for $6.86 per share. The SCC convertible debenture warrant was not registered with the SEC, and thus it was not freely transferable.

In March of 1967, the common stock of SCC was not traded on an established securities market. A prospectus of SCC dated December 21, 1967, stated that the SCC stock warrant and the SCC convertible debenture warrant were issued to Federman Inc. as "consideration" and "compensation" for the underwriting by Federman Inc. of the SCC debentures and therefore that, "Any profits realized on the sale of the warrants, debentures or underlying common stock [which Federman Inc. had received] may constitute additional underwriting compensation."

DPA Inc. Warrants

In January of 1965, Federman Inc. underwrote the issuance by DPA, Inc. (DPA) of 6½-percent subordinated debentures in the aggregate principal amount of $500,000, with warrants attached to purchase 112,500 shares of DPA common stock. Federman Inc. received from DPA a commission of $10,000, and reimbursement for expenses of $1,500 in connection with the underwriting.

Federman Inc. also received from DPA subordinated debentures in the principal amount of $50,000, warrants to purchase 11,250 shares of DPA common stock (the DPA NO. 1 warrants), and warrants to purchase 5,625 shares of DPA common stock (the DPA NO. 2 warrants). In addition to the services it rendered, Federman Inc. paid DPA $50,000 for the debentures, $3,000 for the DPA NO. 1 warrants, and $1,500 for the DPA NO. 2 warrants. The DPA NO. 1 warrants and the DPA NO. 2 warrants were exercisable from March 1, 1966, until July 1, 1970, at an exercise price of $5 per share during the first year, with the price per share escalating $0.50 each succeeding year. In January of 1965, the DPA common stock was not traded on an established market.

In March of 1965, Federman Inc. served as the lead underwriter in connection with the public offering of an additional 165,000 shares of DPA common stock. Federman Inc. received from DPA an underwriting commission of $13,624 in connection with that underwriting. In March of 1965, Federman Inc. also received from DPA warrants to purchase 8,250 shares of DPA common stock (the DPA NO. 3 warrants). Federman Inc. paid DPA $2,500 for the DPA NO. 3 warrants. The DPA NO. 3 warrants were exercisable from April 1, 1966, until March 31, 1969, at an exercise price of $5.35 per share during the first year, with the price escalating $0.35 per share each succeeding year. On the over-the-counter market in March of 1965, the high and low bid prices of the DPA common stock were $12.625 and $5 per share, and the high and low asked prices were $13 and $6.75 per share.

In April of 1965, Federman Inc. served as the lead underwriter in connection with the issuance by DPA of 6-percent subordinated convertible debentures in the principal amount of $1,500,000. Federman Inc. received from DPA a commission of $75,000, and reimbursement for expenses of $5,000 in connection with the underwriting. On April 21, 1965, Federman Inc. also received from DPA warrants to acquire 18,750 shares of DPA stock (the DPA NO. 4 warrants). Federman Inc. paid DPA $3,750 for the DPA NO. 4 warrants. The DPA NO. 4 warrants were exercisable from April 21, 1965, until March 31, 1970, at an exercise price of $7.50 per share. On April 21, 1965, on the over-the-counter market, the high and low bid prices of the DPA common stock were $10.875 and $10.50 per share.

The warrant agreement issued to Federman Inc. in connection with DPA NO. 3 warrants stated that the issuance of the warrants to Federman Inc. was conditioned on the success of the underwriting of DPA's common stock. The warrant agreement also specified that the warrant was not transferable by Federman Inc. except to a successor in a merger or consolidation. Federman Inc. also represented in the warrant agreement that the warrant was being acquired for its own investment account. Additional significant restrictions were set forth in the warrant agreement that restricted Federman Inc.'s right to transfer the underlying common stock should it acquire the stock through exercise of the warrant.

At the time of delivery of the DPA NO. 4 warrant, H. L. Federman, as President of Federman Inc., signed two letter receipts for the warrant and he 'represented and warranted" therein, that the warrant was received for Federman Inc.'s "own account for investment" and that "no other person has any beneficial interest in, or right to acquire, the warrant or the shares of common stock of [DPA] which may be received upon exercise of said warrant." Further, he stated that the warrant was being delivered by DPA to Federman Inc., "as further compensation for [Federman Inc.'s] services" in connection with the underwriting.

ACQUISITION OF THE WARRANTS BY THE SHAREHOLDERS

During the years at issue herein, Federman Inc. sought to attract and retain stockholders and employees by periodically assigning to them a portion of some of the warrants, options, and securities it received for underwriting services rendered. Assignments by Federman Inc. to its shareholders and employees, of the Vernitron, NPDC, SCC, and DPA warrants (herein sometimes referred to collectively as the warrants) occurred as follows:

Warrants	*Shareholder*[1]	*Date of assignment*	*Number assigned*	*Charge to stock account*
Vernitron Corp.	H.L. Federman	Sept. 9, 1966	5,928.00	$59.28
12,500 warrants	L. Barber	Sept. 9, 1966	125.00	1.25
	J. Daley	Sept. 9, 1966	120.00	1.25
	S. Fink	Sept. 9, 1966	3,527.00	35.27
	P. Karp	Sept. 9, 1966	475.00	4.75
	J. Mathes	Sept. 9, 1966	100.00	1.00
	R. Mittman	Sept. 9, 1966	125.00	1.25
	L. Weigl	Sept. 9, 1966	100.00	1.00
	M. Leverton	Sept. 9, 1966	2,000.00	20.00
DPA, Inc. #1	H.L. Federman	Sept. 9, 1966	3,146.13	838.98
11,250 warrants	S. Fink	Sept. 9, 1966	1,850.67	493.50
	L. Eisele	Sept. 9, 1966	444.16	118.44
	H. Moore	Sept. 9, 1966	111.04	29.61
	W. Crawford	June 8, 1966	968.00	258.13
	J. Bloomberg	June 8, 1966	308.50	82.27

[1] Although Federman Inc. retained possession of most of the warrants, it eventually delivered a portion of the warrants to some of the shareholders.

Warrants	*Shareholder*[7]	*Date of assignment*	*Number assigned*	*Charge to stock account*
	R. Mittman	June 8, 1966	154.25	$41.13
	L. Barber	June 8, 1966	154.25	41.13
	H.L. Federman	June 8, 1966	4,113.00	1,096.80
5625 DPA #2	H.L. Federman	June 8, 1966	2,047.00	545.87
warrants	W. Crawford	June 8, 1966	506.00	134.93
	J. Bloomberg	June 8, 1966	153.00	40.81
	R. Mittman	June 8, 1966	77.00	20.53
	L. Barber	June 8, 1966	77.00	20.53
	H.J. Moore	Sept. 9, 1966	55.30	14.75
	L. Eisele	Sept. 9, 1966	221.20	58.99
	S. Fink	Sept. 9, 1966	921.67	245.77
	H.L. Federman	Sept. 9, 1966	1,566.83	417.82
8250 DPA #3	H.L. Federman	June 8, 1966	1,604.00	432.41
warrants[8]	W. Crawford	June 8, 1966	302.00	224.95
	J. Bloomberg	June 8, 1966	121.00	32.62
	R. Mittman	June 8, 1966	60.00	16.17
	L. Barber	June 8, 1966	60.00	16.17
	H.J. Moore	Sept. 9, 1966	43.32	11.69
	L. Eisele	Sept. 9, 1966	173.28	46.79
	S. Fink	Sept. 9, 1966	772.00	194.94
	H.L. Federman	Sept. 9, 1966	1,227.40	331.40
18750 DPA #4	H.L. Federman	June 8, 1966	3,750.00	750.00
warrants[9]	J. Bloomberg	June 8, 1966	281.00	56.20
	R. Mittman	June 8, 1966	140.50	28.10
	L. Barber	June 8, 1966	140.50	28.10
	H.J. Moore	Sept. 9, 1966	101.26	20.25
	L. Eisele	Sept. 9, 1966	405.04	81.01
	S. Fink	Sept. 9, 1966	1,687.67	337.53
	H.L. Federman	Sept. 9, 1966	2,869.03	573.81
Scientific	H.L. Federman	May 4, 1967	7,077.46	1,415.49
Control Corp.	L.Barber	May 4, 1967	225.00	45.00
12,500 warrants	J. Daley	May 4, 1967	106.50	21.30
(25,000 before	S. Fink	May 4, 1967	2,688.54	537.71
adjustment for	P. Karp	May 4, 1967	500.00	100.00
reverse stock	M. Leverton	May 4, 1967	1,500.00	300.00
split)	J. Mathes	May 4, 1967	88.75	17.75
	R. Mittman	May 4, 1967	225.00	45.00
	L. Weigl	May 4, 1967	88.75	17.75

[8] On June 8, 1966, Federman Inc. also assigned 3,937 of the DPA #3 warrants, at a charge of $1,192.92, to Coggeshell & Hicks, an underwriting company which also provided underwriting services to DPA.

[9] On June 8, 1966, Federman Inc. also assigned 9.375 of the DPA #4 warrants, at a charge of $1,875.00 to Coggeshell & Hicks. See note 8 *supra*.

Warrants	*Shareholder*[7]	*Date of assignment*	*Number assigned*	*Charge to stock account*
Scientific	H.L. Federman	Jan. 2, 1968	[10]64.415%	$5,869.00
Control Corp.	L. Barber	Jan. 2, 1968	1.800%	164.00
debenture	J. Daley	Jan. 2, 1968	0.900%	82.00
purchase	S. Fink	Jan. 2, 1968	25.585%	2,331.00
warrant 100%	P. Karp	Jan. 2, 1968	4.000%	365.00
	J. Mathes	Jan. 2, 1968	0.750%	68.00
	R. Mittman	Jan. 2, 1968	1.800%	164.00
	L. Weigl	Jan. 2, 1968	0.750%	68.00
National Patent	H.L. Federman	May 3, 1966	3,000.00	- - -
Development Corp.	H.L. Federman	June 30, 1967	2,180.63	2,180.63
14,400 warrants	M. Leverton	May 3, 1966	7,125.00	- - -
	L. Eisele	June 30, 1967	320.22	320.22
	H.J. Moore	June 30, 1967	80.06	80.06
	L. Barber	June 30, 1967	96.19	96.19
	R. Mittman	June 30, 1967	96.19	96.19
	P. Karp	June 30, 1967	213.75	213.75
	S. Fink	June 30, 1967	1,287.96	1,287.96
National Patent	H.L. Federman	June 30, 1967	1,611.81	1,611.81
Development Corp.	L. Eisele	June 30, 1967	237.22	237.22
3,163 warrants	H.J. Moore	June 30, 1967	59.31	59.31
	R. Mittman	June 30, 1967	71.17	71.17
	L. Barber	June 30, 1967	71.17	71.17
	P. Karp	June 30, 1967	158.15	158.15
	S. Fink	June 30, 1967	954.17	954.17

DISPOSITION OF THE WARRANTS

On November 3, 1967, when the Vernitron common stock was selling on the ASE at $36.50 per share, Federman Inc., for $295,179.15, sold to Commercial Industries warrants to purchase 11,553 shares of Vernitron common stock. Among the warrants sold was a portion of the Vernitron warrants which Federman Inc. had acquired in connection with its July 1966, underwriting of the Vernitron debentures.[11] The proceeds received from Commercial Industries were credited to the investment accounts that were maintained by Federman Inc.

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[10]Federman received 64% of his interest in the SOC debenture warrant as a result of his status as a common stockholder of Federman Inc. and the remainder of his interest as a result of his status as a preferred stockholder.

[11]Federman Inc. received additional warrants to purchase Vernitron stock in other transactions unrelated to the July 1966 underwriting.

in the name of the following individuals and entities, as follows:

Investment account	*Number of warrants sold*	*Proceeds*
H.L. Federman	4,039	$103,312.70
Barber	142	3,640.60
Daley	67	1,717.75
Fink	1,484	37,782.93
Karp	315	8,075.93
Mathes	56	1,435.68
Mittman	142	3,640.60
Weigl	56	1,435.68
Federman Inc.[12]	3,939	100,602.96
J. Weiss[13]	1,313	33,534.32
Total	11,553	295,179.15

In 1968, petitioner Morris Leverton donated 2,000 of his NPDC warrants to a qualified charitable organization and on that basis claimed a charitable deduction of $204,000 on his 1968 Federal income tax return. H.L. Federman donated 113 NPDC warrants to a qualified charitable organization in 1967 and sold 5,000 NPDC warrants for $146,000 in 1968.

On November 18, 1968, Federman Inc. sold 5,170 of the NPDC warrants (4,888 before certain antidilution adjustments) for $580,174.98, and those proceeds were credited to the investment accounts of the following individuals that were maintained by Federman Inc. as follows:

Investment account	*Proceeds*
H.L. Federman	$148,019.34
Barber	19,938.96
Eisele	64,599.66
Fink	267,220.62
Karp	44,306.76
Mittman	19,938.96
Moore	16,150.68
Total	580,174.98

On January 3, 1968, when the value of the SCC common stock was $26 per share, Federman Inc. exercised the SCC stock warrants and paid the exercise price of $31,250 to SCC.

[12] Federman Inc. also maintained a separate investment account for itself.

[13] J. Weiss was an employee of Federman Inc.

Federman Inc. made entries on its books apparently charging each shareholder his pro rata share of the exercise price.

On September 13, 1967, when the fair market value of the DPA common stock was $10 per share, 30,563 of the DPA NO. 1 through NO. 4 warrants were exercised by Federman Inc., and Federman Inc. paid the exercise price of $185,761.56 to DPA. Federman Inc. made entries on its books apparently charging each shareholder his pro rata share of the exercise price.

Neither Federman Inc. nor the shareholders reported any income on their Federal income tax returns in connection with their receipt of any of the warrants. The shareholders did, however, report long-term capital gain when the warrants or the shares of stock acquired as a result of the exercise of the warrants were subsequently sold.

In his notices of deficiency, respondent determined that the warrants did not have a "readily ascertainable fair market value" within the meaning of sections 1.61–15 and 1.421–6, Income Tax Regs., at the time Federman Inc. first received them, and that, therefore, Federman Inc. realized compensation income, and the shareholders realized dividend income, when the warrants were either exercised or transferred by Federman Inc. in an arm's-length transaction. The amount determined by respondent of compensation income to Federman Inc. and dividend income to the shareholders was either the difference between the exercise price and the value of the property received upon exercise of the warrants or the amount of any gain resulting from transfer of the warrants.

THE ANNUITY TRANSACTION

On April 15, 1968, Yaacov Meridor, an Israeli citizen, established a trust under the laws of the Bahama Islands (herein the trust) by transferring $5,000 to the corpus of the trust and naming H.L. Federman's wife, Sylvia, as the sole beneficiary. Meridor was a friend and business associate of H.L. Federman, and established the trust at H.L. Federman's request. Castle Trust Co., Ltd. (hereinafter referred to as either Castle or the trustee), a trust company incorporated under the laws of the Bahama Islands, was named as the initial trustee of the trust.

Under the terms of the trust agreement, the trustee was authorized to distribute trust corpus to Sylvia Federman and

to loan her money from the trust, interest free. Sylvia Federman was granted a power of appointment over the trust corpus, exercisable in favor of anyone except herself or her creditors. She was also authorized to appoint an "Advisory Committee" consisting of five or less members that was not to include herself or the named settlor, Yaacov Meridor. She was not precluded from appointing H.L. Federman to the advisory committee. That committee was authorized to direct the investments of the trust; and the trustee, in carrying out those directions, would be absolved of any liability for the investments. Additionally, Sylvia Federman was authorized to remove the trustee without cause and to appoint a successor trustee. The trustee's obligation to make the annuity payments was dependent upon the trust's having sufficient assets and income to satisfy that obligation.

On July 3, 1968, H.L. Federman entered into an annuity agreement with Castle, as trustee of the trust, under which he agreed to transfer his 64-percent equitable interest in the SCC convertible debenture warrant to the trust in return for an annual payment of $40,612.17 for his life. The amount of the annual payment was calculated on the basis of a fair market value for the 64-percent interest in the SCC convertible debenture warrant of $475,000.[14]

On July 10, 1968, the shareholders who owned the remaining 36-percent equitable interest in the SCC convertible debenture warrant agreed to sell for $325,000 their interests in the warrant to Castle, acting for its own investment account and not in its capacity as trustee of the trust. The agreement provided that $100,000 of the purchase price was payable by Castle on August 15, 1968, and the balance was due on January 31, 1969.[15]

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[14] The parties used table I of sec. 20.2031-7(f), Gift Tax Regs., to calculate the annual annuity payment of $40,612.17, as follows:

Federman's age	59
Present worth of the annuity under table I, sec. 20.2031-7(f), Gift Tax Regs	11.6960
Agreed fair market value of 64% interest in SCC convertible debenture warrant	$475,000
Annual payment equals	Agreed fair market value / 11.6960

[15] In 1968 payment of $315,415 of the $325,000 purchase price owed by Castle was actually made by Federman Inc., not by Castle.

After the equitable interest in the SCC convertible debenture warrant was transferred to Castle, both as trustee of the trust (64-percent) and for its own investment account (36-percent), Federman Inc. immediately exercised the warrant on behalf of both the trust and Castle by purchasing SCC convertible debentures for $250,000. Then, on July 24, 1968, after the debentures were converted into 36,443 shares of SCC common stock, Federman Inc. entered into an agreement with Patrick Martin (Martin) for the sale to Martin of those shares for $1,202,619, or $33 per share, as well as for the sale of an additional 95,000 shares of SCC common stock, also at $33 per share.

The annuity agreement represented the culmination of protracted negotiations between H.L. Federman and Martin whereby Martin sought to gain control of SCC. In the agreement, Federman Inc. represented that it was "acting as principal and as agent for certain holders of the common stock [SCC]." The annuity agreement was executed by H.L. Federman on behalf of Federman Inc., by H.L. Federman, individually, and by Martin, but was not executed by or on behalf of Castle or the trust.

Martin agreed to pay $100,000 of the $1,202,619 purchase price for the 36,443 shares upon the execution of the annuity agreement, with $250,000 due November 11, 1968, and the remaining balance due on or before December 11, 1968. Martin made these payments directly to Federman Inc. After deducting advances it had made on behalf of the trust and Castle, including amounts it paid to exercise the SCC debenture warrant and to convert the debenture into SCC stock, Federman Inc. turned the remaining proceeds over to Castle. Federman Inc. also charged the trust and Castle $54,665 as a commission for the sale of the 36,443 shares.

At no time relevant to the instant case did Sylvia Federman know that she was the beneficiary of the trust nor, for that matter, was she even aware that the trust existed. H.L. Federman made all business and financial decisions for himself and his wife. When H.L. Federman asked his wife to execute documents, she would often do so without reading them or questioning H.L. Federman about their contents.

Sometime between 1969 and 1972, the trust made an interest-free, unsecured loan of approximately $400,000 nomi-

nally to Sylvia Federman. The trust gave the loan proceeds directly to H.L. Federman, and he immediately reloaned the money to Federman Inc. Sylvia Federman was never aware that either of these loans had been made. Subsequently, Federman Inc. was liquidated after suffering severe financial difficulties and neither H.L. Federman, Sylvia Federman, nor Federman Inc. ever repaid the loan to the trust.

During the period of 1969 through 1971, H.L. Federman received three "annuity payments" of $40,612.17 from the trust. Thereafter, no further "annuity payments" were made to H.L. Federman.

On their 1968 Federal income tax return, H.L. and Sylvia Federman reported no gain from the transfer of H.L. Federman's 64-percent interest in the SCC debenture warrant to the trust, nor did they report any gain from the subsequent sale of the SCC stock acquired as a result of the exercise of that warrant.[16] In his notice of deficiency, respondent determined that the Federmans realized ordinary income of $561,488 as a result of these transactions.

OPINION

Issue 1. Capacity in Which Federman Inc. Received the Warrants

The question of who is the owner of property for Federal income tax purposes is a question of fact that must be determined from an examination of all the relevant facts and circumstances. *Schoenberg v. Commissioner*, 302 F.2d 416 (8th Cir. 1962), affg. a Memorandum Opinion of this Court; *Snyder v. Commissioner*, 66 T.C. 785 (1976); *Hook v. Commissioner*, 58 T.C. 267 (1972).[17] Such an examination in this case speaks loudly and clearly and allows only one conclusion—namely, that Federman Inc. received the warrants in question herein as a principal, on its own behalf, and as a result of underwriting services it performed. The services were performed and the warrants were received pursuant to legal contracts that required Federman Inc. to perform those services and that

[16] On their 1969 through 1971 Federal income tax returns, Mr. and Mrs. Federman reported long-term capital gains of $25,453.10 based on their receipt of the annuity payments.

[17] See also *Beran v. Commissioner*, T.C. Memo 1980-119.

required the issuing companies to transfer the warrants to Federman Inc. for services rendered.

The warrants were issued to Federman Inc., not to the shareholders. The nominal purchase price that usually was required was paid by Federman Inc., not by the shareholders. Upon acquisition, the warrants were accounted for as warrants of Federman Inc. on Federman Inc.'s records. They were not accounted for as securities of the shareholders or employees, nor were they placed in a nominee or street account.

The extensive documentation associated with the underwriting transactions (as described in the findings of fact herein) uniformly describe the receipt of the warrants by Federman Inc. in its capacity as legal, equitable, and beneficial owner thereof. Affirmative representations by Federman Inc. and by the issuing companies are set forth in the documentation to the effect that Federman Inc. was receiving the warrants on its own behalf and not for anyone else's beneficial or equitable ownership. We so hold.

Petitioners argue that the warrants could not possibly have been owned by Federman Inc. because Federman Inc. did not have enough capital to pay the exercise price. Such an argument we find disingenuous. Federman Inc. and its officers were sophisticated in the securities and financial markets and surely were aware of credit sources to fund the exercise of stock warrants when and if the economics thereof justified exercise of the warrants.

Petitioners argue that we should elevate substance over form and hold that because Federman Inc. (some months after its acquisition of the warrants) transferred some of the warrants to its shareholders, Federman Inc. never was the owner of the warrants. Petitioners' position is completely contrary to both the form and substance of the transactions in question, and we reject petitioner's arguments on this issue.

Issue 2. Were the Warrants Received by Federman Inc. as Compensation for Services Rendered?

The Court having found that the warrants were received by Federman Inc. as the owner thereof, petitioners argue that the receipt of the warrants represented a stock investment by Federman Inc. in exchange for the price paid therefor. See sec.

1.61–15(b)(1)(ii), Income Tax Regs.[18] Respondent argues that the receipt by Federman Inc. of the warrants was compensation for underwriting services rendered.

Again, the documentation associated with each underwriting transaction involved herein establishes the compensatory nature of the receipt by Federman Inc. of the warrants. Self-serving testimony by the individual petitioners herein that the warrants were not received as compensation for underwriting services does not begin to overcome the extensive documentation to the contrary.

Petitioners argue that the fact that Federman Inc. paid some cash for the "purchase" of most of the warrants demonstrates the noncompensatory nature thereof. In fact, the purchase price of the warrants was nominal under any measurement, even taking into account the restrictions placed on the warrants.[19]

Petitioners also argue that since Federman Inc. received cash compensation from the companies for whom it performed the underwriting services, the transfer to Federman Inc. of the warrants was not intended as compensation. We disagree. The warrants clearly represented compensation to Federman Inc. in addition to the cash compensation, and the fact that some regulatory authorities placed limits on the amount of cash compensation underwriters could be paid apparently did not inhibit payment to the underwriters of compensatory stock options in addition to cash compensation. Certainly, in light of the disclosures in the prospectus material concerning the warrants, the regulatory authorities were fully advised of the receipt of the warrants by Federman Inc. and of the compensatory nature thereof, and apparently they raised no objection to

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[18] Sec. 1.61–15(b), Income Tax Regs., in pertinent part provides—

(b) *Options to which paragraph (a) does not apply.* (1) Paragraph (a) of this section does not apply to:

. . . . . .

(ii) An option which is not granted as the payment of an amount constituting compensation, such as an option which is acquired solely as an investment (including an option which is part of an investment unit described in paragraph (b) of sec. 1.1232–3).

[19] As stated earlier, in addition to the services rendered, Federman Inc. paid a total of $125 for the Vernitron warrants; nothing for the NPDC warrants; $2,500 for the SCC warrants; $3,000 for the DPA No. 1 warrants; $1,500 for the DPA No. 2 warrants; $2,500 for the DPA No. 3 warrants; and $3,750 for the DPA No. 4 warrants.

the grant of the warrants to Federman Inc. in the manner and for the purposes described in the prospectus material.

Under section 1.61–15(b)(2), Income Tax Regs., if a nonqualified option or warrant to acquire stock has a readily ascertainable value within the meaning of section 1.421–6, Income Tax Regs., the recipient of the nonqualified option or stock warrant may be able to establish that the option or warrant was not received as compensation for services by showing that the amount of money paid for the option or warrant equaled the fair market value thereof[20] thereby avoiding any compensatory element on receipt of the warrants. This argument, however, is not available to petitioners herein since they concede on brief that the stock warrants in question would not be treated as having a readily ascertainable fair market value at the time of receipt of the warrants if the valuation rules of section 1.421–6, Income Tax Regs., are applicable to the stock warrants in question.[21]

Also, under section 1.61–15(b)(2), Income Tax Regs., if a stock warrant does not have a readily ascertainable fair market value, it may still be possible to establish that the warrant was not received as compensation for services if the recipient can establish that "there was no reason" for the

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[20] Sec. 1.61–15(b)(2), Income Tax Regs., provides—

(2) If a person acquires an option which is not subject to the rules contained in section 421, and if such option has a readily ascertainable fair market value, such person may establish that such option was not acquired as payment of an amount constituting compensation by showing that the amount of money or its equivalent paid for the option equaled the readily ascertainable fair market value of the option. If a person acquires an option which is not subject to the rules contained in section 421, and if such option does not have a readily ascertainable fair market value, then to establish that such option was not acquired as payment of an amount constituting compensation, such person must show that, from an examination of all the surrounding circumstances, there was no reason for the option to have been granted as the payment of an amount constituting compensation. For example, such person must show that he had neither rendered nor was obligated to render substantial services in consideration for the granting of the option. In determining whether an option, such as an option acquired in connection with an obligation as part of an investment unit, has been granted as compensation for services, the ordinary services performed by an investor in his own self-interest in connection with his investing activities will not be treated as the consideration for the grant of the option. For example, if a small business investment company takes an active part in the management of its debtor small business company, the rendering of such management services will not be treated as the consideration for the granting of the option, provided such services are rendered for an independent consideration, or are merely protective of the small business investment company's investment in the borrower. See paragraph (c) of sec. 1.421–6 for the meaning of the term "readily ascertainable fair market value."

[21] The valuation rules of sec. 1.421–6, Income Tax Regs., as in effect during the years involved herein, and the validity thereof are discussed in more detail in connection with our discussion of issue 3 *infra*.

warrant to have been received as compensation for services. As we have stated, the evidence is clear that the warrants received by Federman Inc. were received because of, in connection with, and specifically as compensation for underwriting services rendered by Federman Inc. to the issuing corporations.

Issue 3. When Must Federman Inc. Recognize and Determine the Amount of the Compensation Income it Received as a Result of the Receipt of the Stock Warrants?

Petitioners contend that regardless of the valuation criteria of section 1.421–6(c), Income Tax Regs., as in effect during the years involved herein,[22] the stock warrants in question had a

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[22] Sec. 1.421–6(c), Income Tax Regs., which is applicable to nonstatutory stock options and warrants that were granted on or after Feb. 26, 1945, and before July 1, 1969, provides in pertinent part as follows—

(c) *Options with a readily ascertainable fair market value.* (1) If there is granted an option to which this section applies and which has a readily ascertainable fair market value (determined in accordance with subparagraphs (2) and (3) of this paragraph) at the time the option is granted, the employee in connection with whose employment such option is granted realizes compensation at such time in an amount equal to the excess, if any, of such fair market value over any amount paid for the option. If an option to which this section applies does not have a readily ascertainable fair market value at the time the option is granted, the time when the compensation is realized and the amount of such compensation shall be determined under paragraph (d) of this section.

(2) Although options may have a value at the time they are granted, that value is ordinarily not readily ascertainable unless the option is actively traded on an established market. If an option is actively traded on an established market, the fair market value of such option is readily ascertainable for purposes of this section by applying the rules of valuation set forth in sec. 20.2031–2 of this chapter (the Estate Tax Regulations).

(3)(i) When an option is not actively traded on an established market, the fair market value of the option is not readily ascertainable unless the fair market value of the option can be measured with reasonable accuracy. For purposes of this section, if an option is not actively traded on an established market, the option does not have a readily ascertainable fair market value when granted unless the taxpayer can show that all of the following conditions exist:

(*a*) The option is freely transferable by the optionee;

(*b*) The option is exercisable immediately in full by the optionee;

(*c*) The option or the property subject to the option is not subject to any restriction or condition * * * which has a significant effect upon the fair market value of the option or such property; and

(*d*) The fair market value of the option privilege is readily ascertainable in accordance with subdivision (ii) of this subparagraph.

(ii) The option privilege in the case of an option to buy is the opportunity to benefit during the option's exercise period from any increase in the value of property subject to the option during such period, without risking any capital. Similarly, the option privilege in the case of an option to sell is the opportunity to benefit during the exercise period from a decrease in the value of the property subject to the option. For example, if at some time during the exercise period of an option to buy, the fair market value of the property subject to the option is greater than the option's exercise price, a profit may be realized by exercising the option and immediately selling the property so acquired for its higher fair market value. Irrespective of whether any such gain may be realized immediately at the time an option is granted, the fair market value of an option includes

readily ascertainable fair market value upon receipt by Federman Inc. Petitioners therefore contend that the value of the warrants must be determined and includable in petitioners' income at that time. Petitioners' contentions are based on the argument that the regulations are invalid insofar as they make the valuation rules set forth therein applicable to independent contractors and that the specific rules provided in the regulations for stock options and warrants are invalid.

Respondent contends that the regulations are valid and that under the valuation rules set forth therein, the value of the warrants in question could not be determined on the date the warrants were received by Federman Inc. and therefore the value of the warrants and the amount of compensation income Federman Inc. must report with respect thereto must be determined on the date of exercise of the warrants or on the date of an arm's-length transfer of the warrants, if such a transfer occurred before the warrants were exercised.

The applicable Treasury regulation specifically provides that the valuation rules of section 1.421–6, Income Tax Regs., apply not only to employees but also to independent contractors. Express reference also is made in the regulation to the application of those valuation rules to underwriters of securities.[23]

Treasury regulations are not to be rejected unless they are found to be unreasonable and plainly inconsistent with the statute, *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948). Treasury regulations, "should not be overruled

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the value of the right to benefit from any future increase in the value of the property subject to the option (relative to the option exercise period), without risking any capital. Therefore, the fair market value of an option is not merely the difference that may exist at a particular time between the option's exercise price and the value of the property subject to the option, but also includes the value of the option privilege for the remainder of the exercise period. Accordingly, for purposes of this section, in determining whether the fair market value of an option is readily ascertainable, it is necessary to consider whether the value of the entire option privilege can be measured with reasonable accuracy. In determining whether the value of the option privilege is readily ascertainable, and in determining the amount of such value when such value is readily ascertainable, it is necessary to consider—

(a) Whether the value of the property subject to the option can be ascertained;

(b) The probability of any ascertainable value of such property increasing or decreasing; and

(c) The length of the period during which the option can be exercised.

[23] The pertinent portion of sec. 1.61–15(a), Income Tax Regs., provides—

"This section, for example, makes the rules of section 1.421–6 applicable to options granted in whole or partial payment for services of an independent contractor. [See also sec. 1.421–6(b)(3), Income Tax Regs., which makes specific reference to the application of the valuation rules of sec. 1.421–6, Income Tax Regs., to underwriters of securities.]"

except for weighty reasons" (*Bingler v. Johnson*, 394 U.S. 741, 750 (1969); *Edward L. Stephenson Trust v. Commissioner*, 81 T.C. 283, 287 (1983)); and "the choice among reasonable alternatives is for the Commissioner, not the Courts." *National Muffler Dealers Association v. United States*, 440 U.S. 472, 488 (1979); *Allen Oil Co. v. Commissioner*, 614 F.2d 336, 340 (2d Cir. 1980).

A significant factor in considering the validity of Treasury regulations is the length of time the regulations have been outstanding. *United States v. Correll*, 389 U.S. 299, 305–306 (1967); *Commissioner v. Estate of Sternberger*, 348 U.S. 187, 190 (1955). An application of the above standards to section 1.61–15, and to section 1.421–6, Income Tax Regs., requires a decision upholding the validity of those regulations.

Petitioners refer to a number of the early changes made to sections 1.61–15, and to section 1.421–6, Income Tax Regs.,[24] and petitioners infer therefrom that the Treasury initially doubted the propriety of applying the valuation rules of section 1.421–6, Income Tax Regs., to independent contractors. Although some of the early changes in the regulations may have reflected some uncertainty on the part of the Treasury in the late 1950's and early 1960's as to the treatment of stock options received by independent contractors, they do not suggest any uncertainty in that regard on the part of the Treasury in the more recent 20-plus years since the regulations were finalized.

Contrary to petitioners' contention, the significance, if any, to be drawn from the background of section 1.61–15, Income Tax Regs., is that the instant question received considerable attention prior to the finalization of the regulations in 1963. For example, the identical argument asserted by petitioner herein (namely, that the tax treatment of stock options received by independent contractors for services rendered should be different from the tax treatment of stock options

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[24] As originally proposed on Nov. 10, 1956, sec. 1.421–6, Income Tax Regs., was not made applicable to independent contractors. 21 Fed. Reg. 8774 (1956). However, in 1959 when the regulation was issued in final form it was made applicable to independent contractors. T.D. 6416, 1959–2 C.B. 126 (Sept. 22, 1959). Thereafter independent contractors were alternatively excluded, included, and then once again excluded from the coverage of the regulation. See T.D. 6481, 1960–2 C.B. 159 (July 8, 1960), and T.D. 6540, 1961–1 C.B. 161 (Jan. 17, 1961). Finally, on Dec. 9, 1963, sec. 1.421–6, Income Tax Regs., was once again made applicable to independent contractors by the promulgation of sec. 1.61–15, Income Tax Regs. T.D. 6696, 1963–2 C.B. 23.

received by employees) was made in 1960, in Fleischer & Meyer, "Tax Treatment of Securities Compensation: Problems of Underwriters," 16 Tax L. Rev. 119, 147 (1960). See also Horwich, "Tale of Two Dicta: The Non-Restricted Stock Option" 18 U. Miami L. Rev. 596, 601 (1964); Baker "Nonstatutory Stock Options," 87-3rd Tax Management A-2—A-3 (1983) (87-3rd Tax Management was revised and superseded in 1984 by Billman, "Nonstatutory Stock Options," 383 Tax Management). That argument was rejected in 1963 by the adoption of section 1.61-15, Income Tax Regs., and we discern no basis for rejecting those regulatory provisions today.

Court decisions that have addressed the tax rules applicable to the receipt of stock options by independent contractors support the validity of section 1.61-15 and section 1.421-6, Income Tax Regs. In affirming a Memorandum Opinion of this Court, the Second Circuit, in *Victorson v. Commissioner*, 326 F.2d 264 (2d Cir. 1964), held that a right to purchase stock that was given to an underwriter for services rendered was an option, and measured the taxable income to the underwriter as of the date the option was exercised. Although the years involved in that case preceded the effective date of the regulations, the Second Circuit expressly stated that "Treas. Regs. §1.421-6(d)(2)(i) * * * was made applicable to underwriters' stock options by Treas. Dec. 6669." (326 F.2d at 267 n. 2.)

LeVant v. Commissioner, 45 T.C. 185 (1965), revd. and remanded on another issue 376 F.2d 434 (7th Cir. 1967), primarily concerned the proper tax treatment of an exchange of stock options for stock in another corporation. The individual taxpayer in that case initially had been an independent contractor and then converted to employee status. This Court discussed at length the valuation rules of section 1.421-6, Income Tax Regs., and specifically commented on the application of section 1.61-15, Income Tax Regs., as follows:

> Section 1.61-15, Income Tax Regs., provides that if a person receives an option, not subject to section 421, in payment of an amount constituting compensation of such person, such option is subject to the rules contained in section 1.421-6 of the regulations for purposes of determining when income is realized in connection with such option and the amount of such income. [45 T.C. at 197.]

In *Frank v. Commissioner*, 54 T.C. 75 (1970), affd. 447 F.2d 552 (7th Cir. 1971), which concerned the receipt of options by

an officer-employee, we again commented on the application of section 1.61–15, Income Tax Regs., as follows:

> Section 1.61–15, Income Tax Regs., which was added to the regulations subsequent to the years at issue makes the rules contained in sec. 1.421–6 of such regulation applicable to options granted certain non-employees after July 11, 1963. [54 T.C. at 86 n. 4.][25]

In the above *Frank* opinion, a statement also was made concerning the policy underlying, and the validity of, the valuation rules of section 1.421–6(d), Income Tax Regs., as follows:

> Surely, it cannot be considered unreasonable to require reasonable accuracy in the valuation of stock options. To hold otherwise would be to encourage estimates of fair market value of such rights on the basis of pure speculation and surmise. [54 T.C. at 94.]

That policy is as applicable to options received by independent contractors as it is to options received by employees. See also 2 J. Mertens, Law of Federal Income Taxation, sec. 11.10, at 34–36 (1982 rev.), which comments favorably on the application of the valuation rules of section 1.421–6(d) to independent

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[25] In this Court's opinion in *Victorson v. Commissioner*, T.C. Memo. 1962–231, we stated—

> "On brief petitioners suggest that a different rule may apply in the present case to an underwriter which receives a stock option as part of its compensation for services rendered than in the more usual case of an employee receiving such an option. However, petitioners do not suggest what this different rule should be or why it should be different. Given the same options in both situations, we know of no reason why an independent contractor should be treated differently from an employee with regard to the realization of income upon the exercise of a compensatory stock option. [21 T.C.M. 1238, at 1245 n. 1, 31 P-H Memo T.C. par. 62,231, at 1378–62 n. 1; citations omitted.]"

McNatt v. Commissioner, T.C. Memo. 1962–99, affd. on other issues sub nom. *Frank v. Commissioner*, 321 F.2d 143 (8th Cir. 1963), involved the receipt of options by independent promoters of the stock of a corporation and expressly applied the rationale of *LoBue v. Commissioner*, 351 U.S. 243 (1956), to independent contractors. We stated therein—

> "In the instant case even though the contract does not specifically refer to an option being granted to Frank and McNatt, and Frank and McNatt were not employees of Bankers and Peoples, the agreement to permit them to purchase stock in Bankers and Peoples was in the nature of an option granted to them for services rendered or to be rendered and the problem here involved is similar to that involved in the case of an option given to an employee. [21 T.C.M. 542, at 553, 31 P-H Memo T.C. par. 62,099, at 62–613.]"

Simmons v. Commissioner, T.C. Memo. 1964–237, also involved the receipt of stock options by an underwriter for services rendered. Therein, this Court stated that—

> "receipt of the option does not give rise to income and its realization is deferred until a later time. Quite obviously it was * * * *when the option was exercised*, that petitioners first realized *measurable* economic benefit. [23 T.C.M. 1423, at 1425, 33 P-H Memo T.C. par. 64,237, at 1560–64; emphasis supplied.]"

contractors, pursuant to the authority of section 1.61–15, Income Tax Regs.

The application of the valuation rules of section 1.421–6, Income Tax Regs., in numerous additional court decisions further supports the validity of those valuation rules, as set forth in the regulation. See, for example, *Shamburger v. Commissioner*, 508 F.2d 883 (8th Cir. 1975), affg. 61 T.C. 85 (1973); *Mitchell v. Commissioner*, 590 F.2d 312 (9th Cir. 1979), affg. 65 T.C. 1099 (1976); *Wanvig v. Commissioner*, 295 F. Supp. 882 (E.D. Wis. 1969), affd. on other grounds 423 F.2d 769 (7th Cir. 1970).

Under the valuation rules of section 1.421–6(c), Income Tax Regs., the stock warrants in question herein must be held not to have had an ascertainable fair market value upon receipt by Federman Inc. since (1) they were not traded on an established securities market, (2) they were not transferable by Federman Inc. except under very limited conditions, (3) they were not immediately exercisable, and (4) the value of the option privilege could not have been readily ascertained.

Since the stock warrants involved herein did not have a readily ascertainable fair market value at the time of receipt by Federman Inc., under section 1.421–6(c), Income Tax Regs., the receipt thereof by Federman Inc. was not taxable at that time. Rather, the warrants generally would be taxable to Federman Inc. at the time of exercise of the warrants, or if an arm's-length transfer of the warrants occurred before exercise of the warrants, at the time of the arm's-length transfer.

If a non-arm's-length transfer of the warrants occurred before exercise of the warrants, receipt of the warrants would be taxable to Federman Inc. at the time of exercise of the warrants by the transferee, and the amount of compensation income to Federman Inc. (in the year of exercise by the transferee) would be measured by the difference between the fair market value of the stock received by the transferee on exercise of the warrants and the exercise price of the warrants. Sec. 1.421–6(d), Income Tax Regs.[26] The rationale for

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[26] Sec. 1.421–6(d), Income Tax Regs., provides—

(d) *Options without a readily ascertainable fair market value.* If there is granted an option to which this section applies, and if the option does not have a readily ascertainable fair market value at the time it is granted, the employee in connection with whose employment the option is granted is considered to realize compensation includible in gross income under section 61 at the time and

deferral of the taxation with respect to options and warrants until exercise thereof, where a non-arm's-length transfer of options or warrants occurs, is the same rationale (previously discussed herein) for the deferral of taxation of options and warrants upon original receipt thereof where the fair market value of options and warrants at the time of original receipt is not readily ascertainable.

The periodic transfers on the books of Federman Inc. of the warrants from Federman Inc. to the shareholder and/or employee investment accounts were not made at arm's length. The amounts charged to the shareholders on the books were simply pro rata portions of the nominal amounts Federman Inc. had paid for the warrants. No attempt was made by Federman Inc. or by the shareholder transferees of the warrants to value the warrants or to negotiate the amount to

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in the amount determined in accordance with the following rules of this paragraph:

(1) Except as provided in subparagraph (2) of this paragraph, if the option is exercised by the person to whom it was granted, the employee realizes compensation at the time an unconditional right to receive the property subject to the option is acquired by such person, and the amount of such compensation is the difference between the amount payable for the property and the fair market value of the property at the time an unconditional right to receive the property is acquired. An individual has an unconditional right to receive the property subject to the option when his right to receive such property is not subject to any conditions, other than conditions that may be performed by him at any time. Thus, if an individual who has exercised an option has a right to make payment for the property at any time and to receive the property immediately after making such payment, such individual realizes compensation at the time he exercises the option. However, if an individual who has exercised an option is prevented by the terms of the option contract from making payment immediately or from receiving an immediate transfer of the property after making payment, such individual does not realize compensation at the time he exercises the option. Such individual will not realize compensation until he does acquire the right to make payment immediately and to receive an immediate transfer of the property. For purposes of this paragraph, an unconditional right to receive the property subject to the option shall not be considered to have been acquired before the date on which the option is exercised.

(2)(i) If the option is exercised by the person to whom it was granted but, at the time an unconditional right to receive the property subject to the option is acquired by such person, such property is subject to a restriction which has a significant effect on its value, the employee realizes compensation at the time such restriction lapses or at the time the property is sold or exchanged, in an arm's length transaction, whichever occurs earlier, and the amount of such compensation is the lesser of—

(a) The difference between the amount paid for the property and the fair market value of the property (determined without regard to the restriction) at the time of its acquisition, or

(b) The difference between the amount paid for the property and either its fair market value at the time the restriction lapses or the consideration received upon the sale or exchange, whichever is applicable.

If the property is sold or exchanged in a transaction which is not at arm's length before the time the employee realizes compensation in accordance with this subdivision, any amount of gain which the employee realizes as a result of such sale or exchange is includible in gross income at the time of such sale or exchange, but the amount includible in gross income under this subdivision at the time of the expiration of the restriction or the sale or exchange at arm's length shall be reduced by the amount of gain includible in gross income as a result of the sale or exchange not at arm's length.

be charged to the shareholder accounts at the time the warrants were credited thereto.

For the reasons explained above, the warrants are not taxable to Federman Inc. at the time the warrants originally were received in connection with the underwriting services rendered, nor at the time the bookkeeping entries were made crediting the warrants to the shareholder investment accounts.

A portion of the Vernitron and NPDC warrants involved herein were sold by Federman Inc. and/or by the shareholders prior to exercise of the warrants. To the extent those sales were made in arm's-length transactions, Federman Inc. is taxable in the year of those sales based on the amount realized from the sales over its adjusted basis in the warrants. The net amount realized on the sales is taxable to Federman Inc. as compensation income.

Some of the NPDC warrants were contributed by the shareholder/employees to charitable organizations. Since a charitable contribution is not an arm's-length transaction (*Jones v. Commissioner*, 1 T.C. 1207, 1212 (1943)), Federman Inc. is not to be taxed on the warrants at the time of the contributions of the warrants, but Federman Inc. is taxed on the warrants at the time the recipients of the contributions either exercise the warrants or transfer them in an arm's-length transaction.

As described more fully in our findings of fact, on July 3, 1968, H.L. Federman's interest in the SCC convertible debenture warrant was transferred to a foreign situs trust in return for annual annuity payments for his life of $40,612.17. Additionally, on July 10, 1968, the other shareholders with interests in the SCC convertible debenture warrant sold their interests therein to the same foreign trust. Although the facts are not entirely clear, it appears that the price paid by the foreign trust for the purchase of the shareholders' interests in the SCC convertible debenture warrant and for the annuity obligation given to H.L. Federman was reached at arm's length and reflected the underlying market value of the stock.[27]

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[27] The value placed on the 64-percent interest in the SCC warrant that the foreign trust received from H.L. Federman was $475,000, and the value placed on the remaining 36-percent interest in the SCC warrant that the foreign trust received from the other shareholders was $325,000. Additionally, 2 weeks after it acquired the warrant, on July 24, 1968, the foreign trust

Accordingly, with respect to the SCC convertible debenture warrant, Federman Inc. will be taxed in 1968 on the amount realized by H.L. Federman from the sale of his interest in the warrant (namely, $475,000 reduced by costs) and on the net amount realized by the other shareholders on their sale of their interest in the warrant (namely, $325,000 reduced by costs) to the foreign trust. To the extent respondent disagrees as to the arm's-length nature of the amount paid by the foreign trust or of the value placed on the annuity, respondent should notify the Court and a further hearing will be held with respect thereto in connection with further hearings that may be required herein on questions of fair market value.

The remaining Vernitron, NPDC, and DPA warrants (that were exercised directly by Federman Inc. or by the shareholders) will be taxable to Federman Inc. in the year the respective warrants were exercised, and the compensation income to be taxed to Federman Inc. will be calculated based on the difference between the costs associated with the acquisition of the stock (namely, warrant price plus exercise price) and the fair market value of the stock received.

Issue 4. Did the Shareholders Realize Dividend Income Upon the Transfer by Federman Inc. of the Warrants to Them? If so, How Is That Income to be Measured?

The issue of whether the shareholders of Federman Inc. (individual petitioners herein) are to be taxed on the transfer by Federman Inc. of the warrants to acquire the stock turns, in part, on whether the options were transferred to the individual petitioners as compensation for services rendered.[28] If so, the receipt of the stock warrants by the shareholders is governed by section 1.61–15(b) and section 1.421–6, Income Tax Regs. (the validity and application of which previously

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simultaneously exercised the warrant, paid the exercise price of $250,000, received the convertible debenture, converted the debenture into SCC common stock, and sold the SCC common stock so acquired for $1,202,619. This latter amount (apparently reflecting a sale of securities in the open market and therefore an arm's-length transaction) appears to correlate with the total value of $1,050,000 placed on the SCC warrant by the foreign trust at the time that the debenture warrant was transferred to it, when the additional expenses of selling the stock are taken into account.

Our conclusion as to the arm's-length nature of the value placed on the SCC warrant by the foreign trust pertains solely to the instant issue. See our opinion herein, *infra*, concerning the tax effect of the annuity transaction.

[28] This issue is to be distinguished from issue 2, *supra*, which pertained to the compensatory nature of the warrants to Federman Inc.

have been discussed herein), and the shareholders would not realize ordinary income at the time their investment accounts were credited with the shares but at the time of a subsequent exercise or arm's-length transfer of the warrants.

Based on our examination of the evidence, it is concluded that the warrants were not transferred to the shareholders as compensation for services rendered but as a distribution of corporate property. This conclusion is supported by the essentially pro rata nature of the distributions of the warrants to the shareholders of Federman Inc., and by the extensive documentation in evidence which consistently refers to the transfer of the warrants to the shareholders as dividend distributions.

The Federal income tax consequences of distributions of corporate property are governed generally by the rules of sections 301 and 317. Section 301(a) provides as follows:

SEC. 301(a). IN GENERAL.—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

The above statutory language is clearly broad enough to include options and warrants to acquire stock in another corporation, unless such options and warrants are not "property" as defined in section 317(a). The definition of property in section 317(a) is very broad and includes all types of property except the distributing corporation's own stock and options or warrants to acquire such stock. Section 317(a) provides—

SEC. 317(a). PROPERTY.—For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

It follows from the above statutory provisions that a distribution by a corporation to its shareholders of options to acquire stock in another corporation is a dividend if the distributing corporation has sufficient earnings and profits.[29]

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[29]The applicability (to a transaction governed by the Internal Revenue Code of 1954, as amended) of dicta to the contrary in a pre-1954 Code decision of the Supreme Court (*Palmer v. United States*, 302 U.S. 63 (1937)), is highly questionable. That dictum stated that—

"The mere issue of rights to subscribe and their receipt by stockholders, is not a dividend. No

As explained by the Supreme Court in *Commissioner v. Gordon*, 391 U.S. 83, 89 (1968)—

> Whether the actual dividend occurs at the moment when valuable rights [such as stock options and warrants] are distributed or at the moment when their value is realized through sale or exercise, it is clear that when a corporation sells corporate property to stockholders or their assignees at less than its fair market value, thus diminishing the net worth of the corporation, it is engaging in a "distribution of property" as that term is used in § 316. [Fn. ref. omitted.]

The time when a dividend distribution must be included in income of the shareholder and the amount of the distribution are determined according to section 1.301–1(b), Income Tax Regs., as follows:

> (b) *Time of inclusion in gross income and of determination of fair market value.*—A distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands. However, if such distribution is a distribution other than in cash, the fair market value of the property shall be determined as of the date of distribution without regard to whether such date is the same as that on which the distribution is includible in gross income.

Generally, pursuant to the above regulation, the value to a shareholder of a dividend distribution will be determined at the time of the distribution. Under the open transaction doctrine of *Burnet v. Logan*, 283 U.S. 404 (1931), however, the amount to a shareholder of a dividend of property other than cash will be determined at a later time if, as of the date of the dividend or of the declaration thereof, the fair market value of the property distributed cannot be ascertained. *Baumer v. United States*, 580 F.2d 863 (5th Cir.), rehearing denied 585 F.2d 520 (1978).

Only "in rare and extraordinary cases does property have no fair market value." Sec. 1.453–6, Income Tax Regs. In "those

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distribution of corporate assets or diminution of the net worth of the corporation results in any practical sense. * * * 'They are at most options or continuing offers, potential sources of income to the stockholders through sale or the exercise of the rights. [302 U.S. at 71.]"

For an extensive discussion of *Palmer* and the confusion caused by the above-quoted dicta, see Gann, "Taxation of Stock Rights and Other Options: Another Look at the Persistence of *Palmer v. Commissioner*," 1979 Duke L. J. (Pt. 2) 911; Carlson, "Taxation of 'Taxable' Stock Rights: The Strange Persistence of *Palmer v. Commissioner*," 23 Tax L. Rev. 123 (1967–68); *Baumer v. United States*, 580 F.2d 863, 878–884 (5th Cir.), rehearing denied 585 F.2d 520 (1978).

rare circumstances where no fair market value of the property [distributed] can be ascertained * * * the courts have found it necessary to treat the transaction as 'open' until the value can be ascertained." *Baumer v. United States*, *supra* at 885. See also *Burnet v. Logan*, *supra*; *Estate of Meade v. Commissioner*, 489 F.2d 161, 163 (5th Cir. 1974), cert. denied 419 U.S. 882 (1974); *Dennis v. Commissioner*, 473 F.2d 274, 285 (5th Cir. 1973).

Respondent argues that the valuation rules of section 1.421–6, Income Tax Regs. (the specific provisions of which have been explained in connection with our discussion of the taxability to Federman Inc. of its receipt of the warrants), as a matter of law, should govern our determination under section 1.301–1(b), Income Tax Regs., of the value of the warrants that were distributed to the shareholders. Respondent points out that if the valuation rules of section 1.421–6, Income Tax Regs., are not applied to our determination of the amount of the dividend distribution of the warrants, the anomalous result may be produced that the warrants are not taxed to Federman Inc. as compensation income until the time of exercise of the warrants (under the valuation rules of section 1.421–6, Income Tax Regs.), but the warrants are taxed to the shareholders as dividend income at the time of the shareholder distributions (under section 1.301–1(b), Income Tax Regs.).

There is some authority that the valuation rules of section 1.421–6, Income Tax Regs., may be relevant to determine the valuation of property under section 1.301–1(b), Income Tax Regs. See *Baumer v. United States*, *supra* at 885. We are not convinced at this point, however, that the valuation rules of section 1.421–6, Income Tax Regs., as a matter of law, should govern the valuation necessary under section 1.301–1(b), Income Tax Regs., and we defer ruling on that specific point.

In this case, the parties have not yet submitted evidence as to the fair market value, at any point in time, of the warrants in question, and they have stipulated that all questions of fair market value will be deferred until resolution of the other issues addressed herein. Accordingly, the parties are to notify the Court as to whether it will be necessary to schedule for further hearings this issue concerning the value of the dividend distributions along with other valuation issues.

Issue 5. Annuity Transaction

The final issue requires us to determine the Federal income tax consequences to petitioners H.L. Federman and Sylvia Federman of the sale of a 64-percent equitable interest in the SCC convertible debenture warrant to the foreign trust and of the subsequent sale of the stock acquired by the foreign trust as a result of the exercise of the warrant. Petitioners H.L. Federman and Sylvia Federman contend that H.L. Federman sold his interest in the warrant to the trust in exchange for an annual annuity and that the gain on the sale should be recognized only when the annual annuity payments are received.[30] See sec. 72; Rev. Rul. 69–74, 1969–1 C.B. 43. Respondent counters that the transaction did not constitute a bona fide exchange for an annuity. Instead, respondent argues that the transfer of the 64-percent interest in the warrant and the subsequent sale of the stock by the trust constituted, in substance, nothing more than the sale of that stock by H.L. Federman in his individual capacity and should be taxed accordingly. For the reasons set forth below, we agree with respondent that H.L. Federman's transfer of his interest in the warrant was not a bona fide exchange for an annuity. However, rather than concluding, as respondent does, that the substance of the transaction was simply the sale of the SCC stock by H.L. Federman, we find, instead, that H.L. Federman transferred the warrants in trust and that based on his relationship to the foreign trust he is taxable on the trust's income pursuant to the grantor trust rules of sections 671 through 678.

The pivotal question is whether H.L. Federman retained control and beneficial enjoyment of the warrants transferred to the trust.[31] Although a taxpayer has the legal right to structure a transaction so as to lower his tax liability (see *Gregory v. Helvering*, 293 U.S. 465, 469 (1935)), it is well established that Federal tax consequences turn on the substance of a transaction rather than on its form, unless a particular statute indicates that the form is to govern. See

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[30] On their 1969 through 1971 joint Federal income tax returns, Mr. & Mrs. Federman reported long-term capital gains of $25,453.10 based on their receipt of annuity payments.

[31] In his notice of deficiency, respondent did not assert this issue and, consequently, the burden of proof is on respondent as to this issue. Rule 142(a), Tax Court Rules of Practice and Procedure.

Stern v. Commissioner, 747 F.2d 555, 558 (9th Cir. 1984), revg. and remanding 77 T.C. 614 (1981); *Lazarus v. Commissioner*, 58 T.C. 854, 864 (1972), affd. 513 F.2d 824 (9th Cir. 1975). More particularly, "in determining whether [taxpayers] have structured a valid annuity plan or have simply transferred property in trust and reserved a life estate therein, substance and not form is controlling. The essence of the arrangement 'is determined not by subtleties of draftsmanship but by their total effect.'" *Lazarus v. Commissioner*, *supra* at 828–829.

In determining whether a series of related transactions that took the form of a sale of property to a trust in exchange for an annuity was, in substance, a transfer in trust by a grantor-owner, this Court has looked at several factors, including: (1) The relationship between the creation of the trust and the transfer of property to the trust; (2) the relationship between the income generated by the transferred property and the amount of the annuity payments; (3) the degree of control over the transferred properties exercisable by the annuitant; (4) the nature and extent of the annuitant's continuing interest in the transferred properties; (5) the source of the annuity payment; and (6) the arm's-length nature of the annuity/sale arrangement. See *Stern v. Commissioner*, *supra*; *La Fargue v. Commissioner*, 73 T.C. 40 (1979), affd. in part and revd. in part 689 F.2d 845 (9th Cir. 1982);[32] *Lazarus v. Commissioner*, *supra*; *Estate of Fabric v. Commissioner*, 83 T.C. 932 (1984); *Bixby v. Commissioner*, 58 T.C. 757 (1972); *Archbishop Samuel Trust v. Commissioner*, 36 T.C. 641 (1961); affd. sub nom. *Samuel v. Commissioner*, 306 F.2d 682 (1st Cir. 1962).[33]

In the context of the instant case, we find that this issue can be decided primarily on the basis of the degree of control Federman maintained over the transferred property. In *Samuel v. Commissioner*, *supra* at 687, the Court of Appeals for the First Circuit stated—

> Inherent in the concept of an annuity is a transfer of cash or property from one party to another in return for a promise to pay a specific periodic sum for a stipulated time interval. As such, an annuity contract gives rise to a debtor-creditor relationship between the transferee and transferor. * * *

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[32] We express no opinion herein as to whether we agree with the Ninth Circuit's reversals of our opinions in *Stern v. Commissioner*, 747 F.2d 555 (9th Cir. 1984), and *La Fargue v. Commissioner*, 73 T.C. 40 (1979), affd. in part and revd. in part 689 F.2d 845 (9th Cir. 1982)

[33] See also *Horstmier v. Commissioner*, T.C. Memo. 1983-409.

> * * * once the annuitant has transferred the cash or property to the obligor and has received his contractual right to periodic payments, he is unconcerned with the ultimate disposition of the property transferred once it is in the obligor's hands.

The test of control that can be drawn from *Samuel* is a practical one—that is, whether or not the purported annuitant maintained "effective control" of the transferred property. Moreover, as we stated in *Bixby v. Commissioner*, 58 T.C. 757, 789 (1972), this test—

> should be applied in a strict fashion in order to curb abuses in the area of private annuities. The outcome in each case will depend upon the attendant facts as viewed, we hope, in the light of reality. The fact that "annuity agreements" were executed is, of course, not controlling.

In this case, it is clear that H.L. Federman retained effective control of his interest in the SCC debenture warrant. For example, one of the trust provisions allows Mrs. Federman, as the beneficiary of the trust, to exercise her power of appointment over the trust assets in favor of H.L. Federman. Since H.L. Federman made all of Mrs. Federman's business and financial decisions, this provision of the trust effectively preserved control over the transferred property in H.L. Federman.

H.L. Federman's continuing control of the transferred property is also evidenced by other trust provisions that permit the trustee to lend Sylvia Federman money on an unsecured, interest-free basis and to distribute all of the corpus or income to her. While those decisions would have to be made by the trustee, the evidence in this case demonstrates that the trustee maintained little, if any, independence from H.L. Federman. For instance, the sale by the foreign trust of the SCC shares acquired as a result of the exercise of the SCC debenture warrant was negotiated exclusively by H.L. Federman and Federman Inc. Although petitioners contend that H.L. Federman and Federman Inc. were acting merely as agents of the trust, neither of them executed the agreement on behalf of either Castle or the trust. Similarly, we find it difficult to believe that the trustee was acting independently of H.L. Federman when it made the unsecured, interest-free loan of approximately $400,000 to Sylvia Federman. The trustee

never consulted Sylvia Federman before making the loan, and the proceeds of the loan were paid directly to H.L. Federman.

The trustee's lack of independence from H.L. Federman was anticipated in, and was facilitated by, the provisions of the trust agreement. Thereunder, Sylvia Federman had the right to appoint H.L. Federman as the sole member of the "Advisory Committee." In that event, H.L. Federman would have had the power to direct the investment of the trust assets, and the trustee would have been absolved of any liability for imprudent investments of trust principal. Although the record does not indicate whether such an appointment was ever made, it is clear from the record that H.L. Federman acted as if he had that authority.

In addition, the tie-in between the obligation to make the annuity payments and the trust's income (as evidenced by the trust's failure to make the annual annuity payments after the default occurred on the $100,000 unsecured loan owed to the trust) supports our holding that the transfer was not a sale in exchange for an annuity but a transfer in trust with retained control over the trust property. See *Stern v. Commissioner*, *supra* at 558, *Estate of Fabric v. Commissioner*, *supra* at 939.

In summary, based primarily on H.L. Federman's control over the trust and, therefore, over the SCC debenture warrant after it was transferred to the trust and on the tie-in between the annuity payments and the trust's income, we conclude that the transaction was in substance a transfer in trust subject to retained control and beneficial enjoyment of the property.

In view of the above holding, we also find that H.L. Federman was the settlor of the trust and that the named settlor, Yaacov Meridor, H.L. Federman's friend and business associate, was the settlor in name only. This conclusion is based on the following factors: (1) The named settlor contributed only a nominal amount of the trust's corpus ($5,000) in comparison to the substantial amount transferred to the trust by H.L. Federman (see *Bixby v. Commissioner*, *supra*); (2) the creation of the trust and the transfer by H.L. Federman occurred in relatively close proximity of time (see *Estate of Schwartz v. Commissioner*, 9 T.C. 229, 239 (1947)); (3) the named settlor's attenuated connection to Sylvia Federman; and (4) the named beneficiary of the trust reflects H.L.

Federman's desires as to the lifetime and testamentary disposition of his property.

Finally, since H.L. Federman was in substance the grantor of the trust, the grantor trust rules of sections 671 through 678 come into play. Under those rules, H.L. Federman is taxable on the income attributable to any portion of a trust over which he is deemed to be the "owner." Sec. 671. Since Sylvia Federman had the right, through her power of appointment, to demand that all of the trust income and corpus be distributed to H.L. Federman at any time, and since H.L. Federman made all financial decisions for Sylvia Federman, under section 677(a)(1), H.L. Federman must be treated as the owner of the entire trust for purposes of the grantor trust rules. Accordingly, in 1968 H.L. Federman is taxable on the entire amount of the trust income, including the gain the trust realized from the July 24, 1968, sale of the SCC stock.

To reflect the foregoing,

An appropriate order will be entered.

Reviewed by the Court.

DAWSON, STERRETT, WILBUR, NIMS, PARKER, SHIELDS, CLAPP, and JACOBS, *JJ.*, agree with the majority opinion.

SIMPSON, WHITAKER, KÖRNER, and GERBER, *JJ.*, did not participate in the consideration of this case.

FAY, *J.*, dissenting: I respectfully dissent as to the majority's holding that "the readily ascertainable fair market value" rules of sections 1.61–15 and 1.421–6, Income Tax Regs., are valid insofar as they apply to stock warrants received as compensation by independent contractors. I disagree with what I consider to be the majority's conclusory analysis and its expansive use of prior case law to resolve this issue.

First, the majority emphasizes that the regulations here in issue have been in existence for over 20 years and are thus entitled to great deference. Such emphasis implies that the regulations have been applicable to all options granted since the date of their adoption. In fact, however, these regulations apply to options granted before July 1, 1969. See sec.

1.421–6(a)(2), Income Tax Regs. As to options granted on and after that date, section 1.83–7, Income Tax Regs., and not section 1.421–6, Income Tax Regs., is the controlling authority. See sec. 1.83–8(b), Income Tax Regs. Thus, while the regulations may have been in existence for over 20 years, they have been inapplicable with respect to options granted during the last 15 of those years.

Morecver, the majority cites several cases which it contends support the validity of the regulations. See pp. 1215–1217 *supra*. However, none of these cases specifically considered whether section 1.61–15, Income Tax Regs., is valid in making the rules contained in section 1.421–6, Income Tax Regs., applicable to independent contractors. Neither this Court, nor any other Court to our knowledge, has specifically addressed this issue before.

The majority first cites *Victorson v. Commissioner*, 326 F.2d 264 (2d Cir. 1964), and notes that "although the years involved in that case preceded the effective date of the regulations, the Second Circuit expressly stated that 'Treas. Regs. §1.421–6(d)(2)(i) * * * was made applicable to underwriters' stock options by Treas. Dec. 6669.' [326 F.2d at 267 n. 2.]" It is difficult to see how this statement, which appears in a footnote in the Second Circuit's opinion, supports the validity of applying the regulations to independent contractors. That court did not even apply, let alone consider the validity of, the regulations. Rather, it merely observed that T.D. 6669 (Dec. 11, 1963) made the rules of section 1.421–6, Income Tax Regs., applicable to options received by underwriters.

The majority next cites *LeVant v. Commissioner*, 45 T.C. 185 (1965), revd. and remanded on another issue 376 F.2d 434 (7th Cir. 1967). It states that, in *LeVant*, this Court "discussed at length the valuation rules of section 1.421–6, Income Tax Regs., and specifically commented on the application of section 1.61–15, Income Tax Regs." In *LeVant*, however, which involved an option received by an employee, the Court did not address the application of section 1.61–15, Income Tax Regs., to independent contractors, nor did it consider whether such application would be valid. Rather, in the context of discussing options granted to employees, it simply paraphrased the language of the regulation. Thus, *LeVant* does not support the

validity of applying the rules of section 1.421–6, Income Tax Regs., to options received by independent contractors.

The majority next cites *Frank v. Commissioner*, 54 T.C. 75 (1970), affd. 447 F.2d 552 (7th Cir. 1971). Once again, it seizes upon language contained in a footnote to conclude that "we again commented on the application of section 1.61–15, Income Tax Regs." In *Frank*, in which the taxpayer was specifically held to be an employee, this Court similarly did not apply or address the validity of section 1.61–15, Income Tax Regs. It merely observed that that section makes the rules contained in section 1.421–6, Income Tax Regs., applicable to options granted to certain non-employees after July 11, 1963.[1]

Thus, the majority concludes that the regulations are valid based on nothing more than the fact that they have been in existence for a long period of time and upon its misconception that several Court decisions support their validity. I do not believe that the majority is justified in implying that the courts in the above-cited cases considered the regulations valid merely because they commented on their applicability. The instant case presents the first opportunity either this or any Court has had to consider the validity of the application of the regulations to options received by independent contractors, and in my view, requires a more thorough analysis.

For the following reasons, I would conclude that sections 1.61–15 and 1.421–6, Income Tax Regs., are invalid to the extent they make the rules of section 1.421–6, Income Tax Regs., applicable to options received as compensation by independent contractors. Accordingly, I would hold that the amount of the corporation's income arising from the receipt of such warrants must be determined at the time the warrants were received, not when the warrants were subsequently exercised or transferred in an arm's-length transaction.

Although Treasury regulations are not to be rejected unless they are found to be unreasonable and plainly inconsistent with the statute (*Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948)), a regulation is not a reasonable statutory interpretation unless it harmonizes with the plain language of

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[1] In note 25 of its opinion, the majority cites several memorandum opinions of this Court. However, in these cases the Court neither applied nor considered the validity of applying the valuation rules of sec. 1.421–6, Income Tax Regs., to stock options received by independent contractors.

the statute, its origins, and its purpose. *National Muffler Dealers Association v. United States*, 440 U.S. 472, 477 (1979).

Sections 1.61–15 and 1.421–6, Income Tax Regs., were promulgated to deal with the administrative difficulties respondent faced in attempting to value nonstatutory options not traded on an established market. It is a basic rule under our tax laws that property received as compensation for services must be included in income to the extent of its fair market value at the time of receipt. See sec. 1.61–2(d)(1), Income Tax Regs. Only in rare and extraordinary cases will property not have an ascertainable value. See *United States v. Davis*, 370 U.S. 65 (1962). In promulgating sections 1.61–15 and 1.421–6, Income Tax Regs., respondent took the position that the receipt of options as compensation can be one of these "rare and extraordinary" cases.

The rules contained in sections 1.61–15 and 1.421–6, Income Tax Regs., were certainly not derived from any specific statutory language. Section 421 provides special tax treatment for certain qualifying options granted to employees; however, no provision is made for options, such as the warrants herein, which do not so qualify. Section 61 simply provides a sweeping definition of "gross income," including "compensation for services, including fees, commissions, and similar items." Sec. 61(a)(1).

The origin of these regulations can be traced instead to a series of cases which culminated in the Supreme Court's decision in *Commissioner v. LoBue*, 351 U.S. 243 (1956). In *LoBue*, the Court was faced with the question of the taxability of options granted to employees. The options at issue were nontransferable and their exercise was conditioned upon the continued employment of the recipient. In holding that the options constituted compensation income to the extent of the difference between the option price and the fair market value of the stock acquired upon the exercise of the options, the Supreme Court stated:

> It is of course possible for the recipient of a stock option to realize an immediate taxable gain. See *Commissioner v. Smith*, 324 U.S. 177, 181–182. The option might have a *readily ascertainable market value* and the recipient might be free to sell his option. But this is not such a case. These three options were not transferable and LoBue's right to buy stock under them was contingent upon his remaining an employee of the company until they were exercised. Moreover, the uniform Treasury practice since 1923 has

been to measure the compensation to employees given stock options subject to contingencies of this sort by the difference between the option price and the market value of the shares at the time the option is exercised. [*Commissioner v. LoBue*, 351 U.S. at 249; emphasis added.]

Clearly, the distinction made in section 1.421–6, Income Tax Regs., between options with and without a "readily ascertainable fair market value" was derived from this language in *LoBue*. However, neither *LoBue* nor any of the preceding cases in this area ever indicated that these rules should be applied, as they are under section 1.61–15, Income Tax Regs., to options received by independent contractors. See *Commissioner v. Smith*, 324 U.S. 177 (1945). *Commissioner v. Estate of Stone*, 210 F.2d 33 (3d Cir. 1954), affg. 19 T.C. 872 (1953); *McNamara v. Commissioner*, 210 F.2d 505 (7th Cir. 1954), revg. 19 T.C. 1001 (1953). For the following reasons, the rationale in *LoBue* strongly suggests that at least in the typical independent contractor situation the Court would have reached the opposite conclusion.

In *LoBue*, the Court emphasized that the stock options at issue were nontransferable *and* the employee's right to exercise them was contingent upon his remaining in the employment of the company. When both of these restrictions are imposed, I think it is clear that the intent of the employer and employee is that the value of the "bargain purchase" made at the time of the exercise of the option, rather than the option itself, will constitute compensation. Through his continued employment, an employee contributes to the appreciation in the value of the stock subject to the option from the date the option is received until the date it is exercised. Thus, in the employee stock option situation there is justification for viewing the "bargain purchase" as compensation. Moreover, where the employee is required to remain in the employment of the company as a condition to exercising the option, there is a real possibility that this condition will not be satisfied and that the option will never even be exercisable. Thus, when such a condition is imposed, it is not inappropriate to defer taxation until the time when the condition is satisfied and the option is in fact exercised.

In contrast, the two factors emphasized in *LoBue* are not present in the typical independent contractor situation. For example, the corporation herein was not under any obligation

to perform services after it received the warrants and, thus, exercise of the warrants could not be made contingent upon continued rendering of services. Although there were various restrictions on the transferability of the warrants and the corporation was generally not allowed to exercise them for a certain period of time, these restrictions were not imposed by the issuers to ensure continued rendering of services but instead were primarily intended to satisfy SEC requirements. Therefore, such restrictions do not change the intent of the parties that the value of the warrants themselves constitute the compensation for the services rendered. Moreover, the sole restriction on exercise of the warrants in this case was the lapse of time, a condition which was certain to eventually be satisfied. Thus, the uncertainty as to whether the warrants would become exercisable which was present in *LoBue*, wherein exercisability was contingent upon future employment, is simply not present here. Finally, since the corporation was not under any obligation to render services after it received the warrants, it certainly could not have been assumed that the corporation would thereafter contribute to any appreciation in the value of the stock subject to the warrants or to the resulting appreciation in the value of the warrants, themselves. Thus, to treat any part of that appreciation as compensation income strikes me as being unreasonable and inconsistent with the plain meaning of the phrase "compensation for services" in section 61.

It is also noteworthy that measuring compensation income on the basis of the "bargain purchase" made at the time of the exercise of the option, rather than by the value of the option when it is received, can have substantial harsh consequences. The corporation herein will be forced to include as ordinary income, rather than capital gain, the appreciation in the stock subject to the warrants, even though such appreciation resulted from the steep rise in stock market prices and was wholly unrelated to the services rendered by the corporation. The following example is helpful in understanding the unfairness of this result.

Assume that an attorney performs services worth approximately $1,000 for a client and, instead of cash, is given warrants similar to the ones given to the corporation herein. The attorney performs no further services for the client. If the

attorney exercises the warrants when the underlying stock has a fair market value of $50,000, he will, under the majority's holding, have $50,000 of ordinary income at the time of exercise, even though his services were only worth approximately $1,000 and he never again dealt with the client. Since the $49,000 increase in value had no relationship to the value of the services rendered, I believe the correct and fair result is for taxability to be governed by section 1.61–2(d), Income Tax Regs., under which receipt of the warrants would be the taxable event, with the measure of income being the fair market value of the warrants on the date received. Thus, in my example, the attorney would include $1,000 in ordinary income at the time the warrants were received, and the $49,000 increase in value would ultimately be taxed as a capital gain. Following this rationale, identical tax consequences would result whether the attorney received warrants for his services or, instead, was paid cash which he then used to purchase such warrants.

The majority states (at page 1216) that the policy underlying the valuation rules of section 1.421–6, Income Tax Regs., is to require reasonable accuracy in the valuation of stock options and asserts that such policy is as applicable to independent contractors as it is to employees. Thus, the majority apparently believes that the application of section 1.421–6, Income Tax Regs., to the warrants received by the corporation herein is valid because its purpose is to defer taxability to the time when the value of such warrants can be accurately determined. However, its position is contradicted by its discussion (at pages 1220–1223) concerning the question of when the shareholders must recognize dividend income. Therein, the majority refuses to accept respondent's argument that, as a matter of law, the rules of section 1.421–6, Income Tax Regs., must be followed in determining the taxability of the shareholders with respect to the distribution of the warrants to them. In so doing, it acknowledges that the warrants may in fact be valued at some time prior to their exercise. If, as the majority implies, the warrants may be valued prior to exercise for purposes of determining taxability to the shareholders, I see no reason why they cannot similarly be valued prior to exercise for the purpose of determining the taxability of the corporation.

Furthermore, the majority states that under *Burnet v. Logan*, 283 U.S. 404 (1931), "the amount to a shareholder of a dividend of property other than cash will be determined at a later time if, as of the date of the dividend or of the declaration thereof, the fair market value of the property distributed cannot be ascertained." The majority also acknowledges, and subsequent case law has made it clear, that a transaction will be treated as "open" only in rare and extraordinary cases where the fair market value of the property cannot be ascertained. However, the majority fails to articulate why this might be one of those "rare and extraordinary" cases. I do not believe that the open transaction doctrine of *Burnet v. Logan*, *supra*, is applicable to the facts before us. I would conclude, consistent with my previous analysis with respect to the corporation, that the warrants can and should be valued when they were assigned to the shareholders.

Since I would hold that sections 1.61–15 and 1.421–6, Income Tax Regs., are invalid as to options received by independent contractors, and that the corporation and shareholders herein have taxable income upon receipt of the warrants, I respectfully dissent.

GOFFE, CHABOT, HAMBLEN, COHEN, and WRIGHT, *JJ.*, agree with this dissent.

LOUIS ONEAL AND SHIRLEY ONEAL, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ARTHUR K. LUND AND COLLEEN M. LUND, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 12511–81, 12512–81, 10961–82. Filed June 4, 1985.

P invests in a coal tax shelter where he signs a "mining lease," which is actually a sublease, affording P the option of paying the royalty specified either by cash or a nonrecourse note. P also enters into a "contract for the sale of coal" with C, giving a nonrecourse note to C in exchange for funds C made available to P, which P then turned over to lessor. No coal was mined or produced under the foregoing lease during the taxable years. *Held*, minimum royalty provision in sec. 1.612–3(b)(3),

Income Tax Regs., is valid following *Wendland v. Commissioner*, 79 T.C. 355 (1982), affd. per curiam 739 F.2d 580 (11th Cir. 1984), affd. sub nom. *Redhouse v. Commissioner*, 728 F.2d 1249 (9th Cir. 1984); and *Wing v. Commissioner*, 81 T.C. 17 (1983). *Held, further*, advanced royalties P "paid" in 1977 and 1978 are not deductible because no coal was ever produced in 1977 and 1978 and the royalties were not paid pursuant to a valid minimum royalty provision as provided in sec. 1.612–3(b)(3), Income Tax Regs. *Held, further*, damages are awarded under sec. 6673, I.R.C. 1954, for maintaining a groundless and frivolous claim.

Gary S. Vandeweghe, for the petitioners.
John O. Kent, for the respondent.

GERBER, *Judge*: Respondent determined deficiencies of the following amounts in petitioners' 1977 and 1978 Federal income taxes:

Petitioners	*Docket No.*	*Taxable year*	*Deficiency*
Oneal	12511–81	1977	$23,439
Oneal	10961–82	1978	17,767
Lund	12512–81	1977	44,712
		1978	30,326

The issues presented for consideration are: (1) Whether petitioners are entitled to deduct certain claimed "advanced minimum royalties" under section 1.612–3(b)(3), Income Tax Regs., and (2) whether damages should be awarded under section 6673.[1]

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated by this reference.

Petitioners resided in San Jose, California, at the time they filed the petitions in these cases. All petitioners filed their 1977 and 1978 joint Federal income tax returns with the Internal Revenue Service Center in Fresno, California. On the Oneals' returns, their occupations were described as "Attorney" and "Housewife" and they deducted royalties in the

[1]Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect for the taxable years at issue.

amount of $45,000 in 1977 and $33,750 in 1978 on Schedule C as lessees of a coal mine. On the Lunds' returns, their occupations were also described as "Attorney" and "Housewife" and they deducted royalties in the amount of $90,000 in 1977 and $67,500 in 1978 on Schedule C as lessees of a coal mine.[2] References to petitioner in the singular will be to Louis Oneal.

This case presents the now-familiar coal lease shelter with a minimum annual royalty payment, most of which is "paid" by means of a nonrecourse note exclusively payable from mining receipts. During 1977, petitioner entered into a coal lease with Wyoming & Western Coal Reserves, Inc. (WW), which lease gave petitioner the right to mine merchantable coal at a specific location in Wyoming. Petitioner agreed to pay a minimum annual royalty payment of $45,000. The minimum annual royalty payment was to be recoverable out of the amount received from coal sold or mined, removed, and marketed, and was nonrefundable. In addition to the "mining lease," petitioner entered into an "addendum to mining lease" with WW. Pursuant to the addendum, petitioner, as lessee, was given the option of paying the minimum annual royalties provided in the lease either by cash or nonrecourse note. If payment by note was desired, then the addendum provided that petitioner was to pay WW on this nonrecourse note from all coal mined from the leased premises in excess of 60,000 tons.[3]

Petitioner paid one-quarter ($11,250) of the 1977 "minimum annual royalty payment" with his own check.[4] Petitioner then borrowed the remaining amount from Coal & Minerals Leasing & Development Corp. (CM). Any funds that CM issued to petitioner, petitioner negotiated to WW pursuant to an "au-

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[2]The facts with respect to petitioners Arthur K. Lund and Colleen M. Lund are the same facts as with respect to petitioners Louis Oneal and Shirley Oneal except for the amount of the "minimum annual royalty." Thus, the text will describe the facts applicable to petitioners Louis Oneal and Shirley Oneal. The amounts applicable to petitioners Arthur K. Lund and Colleen M. Lund include a "minimum annual royalty" of $90,000 in 1977 with the Lunds' paying one-quarter ($22,500) of the 1977 royalty payment with their own check and borrowing the balance from Coal & Minerals Leasing & Development Corp. (CM). The Lunds made part of their royalty payment for 1978 by way of a note in the amount $22,500 to Wyoming & Western Coal Reserves, Inc. (WW).

[3]Petitioner Arthur K. Lund signed a "nonrecourse promissory note" which provided that payment upon the note was to be made from all coal mined in excess of the initial 120,000 tons.

[4]Petitioners Oneal did not make $11,250 of their royalty payment for 1978 because of an order from the attorney general of the State of California against WW arising from alleged securities violations, yet the Oneals claimed a $33,750 royalty deduction in 1978.

thorization to negotiate." Petitioner also entered into a "contract for the sale of coal" with CM under which petitioner agreed to sell coal to CM. Payments of principal and interest prior to the due date were to be made exclusively from receipts of coal mined, removed, and marketed.

The transactional documents executed by petitioners, including the "mining lease," the "addendum to mining lease," the "nonrecourse promissory note," the "authorization to negotiate," and the "contract for the sale of coal," appear to be part of a preprinted promotional package. No coal was mined or sold on the property petitioners leased during the years 1977 or 1978.

On their joint 1977 and 1978 income tax returns, petitioners Oneal attached a Schedule C for petitioner's coal mining business and claimed a deduction of $45,000 for 1977 and $33,750 for 1978 as a minimum royalty with respect to the WW lease. Petitioners Lund claimed a deduction of $90,000 for 1977 and $67,500 for 1978 as a minimum royalty with respect to the WW lease. Respondent, in his notice of deficiency, disallowed petitioners' claimed coal mining deductions in full.

OPINION

With the exception of the amounts "invested," the factual pattern in this case is identical to that in *Ward v. Commissioner*, T.C. Memo. 1984–570, on appeal (9th Cir., Jan. 14, 1985); *Thompson v. Commissioner*, T.C. Memo. 1984–337; and *Walls v. Commissioner*, T.C. Memo. 1983–504. In fact, in all three prior cases and this case, similar arrangements were entered into with the same Wyoming & Western Coal Reserves, Inc., and with the same Coal & Minerals Leasing & Development Corp. The only differences are the amounts involved and minor variations in some detail. The documents executed by petitioner in this case are identical to those set forth in *Ward*, *Thompson*, and *Walls*, even down to the numbering of the paragraphs. We held in those cases that the deduction claimed as "advanced mineral royalties" was not allowable under the amended provisions of section 1.612–3(b)(3), Income Tax Regs., because no coal was produced in the relevant year.

This Court and two circuit courts of appeals have upheld the validity of amended section 1.612–3(b)(3), Income Tax Regs.

Wing v. Commissioner, 81 T.C. 17 (1983); *Wendland v. Commissioner*, 79 T.C. 355 (1982), affd. per curiam 739 F.2d 580 (11th Cir. 1984), affd. sub nom. *Redhouse v. Commissioner*, 728 F.2d 1249 (9th Cir. 1984).

Petitioners attack the validity of the regulations but do not present any new or different arguments. For example, petitioners argue that the doctrine of legislative reenactment invalidates the regulations.[5] Second, petitioners argue that the regulations are invalid because the Internal Revenue Service failed to comply with the Administrative Procedures Act and the Service's own rules by establishing an effective date and suspending two revenue rulings in a news release, by not publishing the amended regulation at least 30 days before its effective date, by abusing its discretion under section 7805 and retroactively amending the regulations, and by arguing that the general provisions of section 7805 control over a more specific section, such as section 612. Petitioners argue that all of these procedural attacks invalidate the regulations or that at least one of these attacks is sufficient to invalidate the regulations. This Court, however, has on several prior occasions confronted all of petitioners' arguments and has rejected them. *Wendland v. Commissioner*, *supra*; *Wing v. Commissioner*, *supra*; *Surloff v. Commissioner*, 81 T.C. 210 (1983); *Elkins v. Commissioner*, 81 T.C. 669 (1983). Due to the extensive rationale already set forth in the above-referenced opinions, nothing would be served to restate it here. We again conclude that the regulations are valid, relying on the cases cited above.

Petitioners next argue that the royalties were paid pursuant to a minimum royalty provision as provided in section 1.612–3(b)(3), Income Tax Regs.[6] Under the regulation, if no

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[5]Petitioners argue that administrative practice reflected in the regulation prior to its 1977 amendment had acquired the force of law and, by virtue of the legislative reenactment doctrine, could not be altered without congressional action. We have held, however, that the legislative reenactment doctrine does not bar respondent from amending the regulation. *Wing v. Commissioner*, 81 T.C. 17, 35–36 (1983); *Wendland v. Commissioner*, 79 T.C. 355, 383–385 (1982), affd. per curiam 739 F.2d 580 (11th Cir. 1984), affd. sub nom. *Redhouse v. Commissioner*, 728 F.2d 1249 (9th Cir. 1984); *Surloff v. Commissioner*, 81 T.C. 210 (1983); and several Memorandum Opinions of this Court, e.g., *Gibson v. Commissioner*, T.C. Memo. 1984–616, and *Chidnese v. Commissioner*, T.C. Memo. 1984–612.

[6]Sec. 1.612–3(b)(3) provides in pertinent part:

"The payor shall treat the advanced royalties paid or accrued in connection with mineral property as deductions from gross income for the year the mineral product, in respect of which the advanced royalties were paid or accrued, is sold. For purposes of the preceding sentence, in the case of mineral sold before production the mineral product is considered to be sold when the

mineral product is produced during a given year, then no royalty deductions are allowed in that year unless royalties are paid or accrued as a result of a provision in the lease requiring that substantially uniform royalties be paid each year of the lease. In the instant case, no coal was mined or sold during 1977 or 1978 on the property petitioners leased. Thus, in order for the royalty payments "paid" by petitioners to be deductible in 1977 or 1978, the payments must have been made pursuant to a valid minimum royalty provision.

Respondent argues that, because petitioners were not required to make annual royalty payments in the absence of mineral production, the payments by petitioners do not satisfy the requirements set forth in section 1.612–3(b)(3), Income Tax Regs. In support of his position, respondent relies on the "addendum to mining lease" which allows petitioners to make future annual royalty payments by the execution of a nonrecourse note. Under the terms of such nonrecourse note, payment would only be made from all coal mined in excess of the initial 60,000 tons.[7]

On several occasions, we have addressed the question of whether a nonrecourse note constitutes payment for purposes of the minimum royalty provision under section 1.612–3(b)(3), Income Tax Regs. *Wing v. Commissioner*, *supra*; *Thompson v. Commissioner*, *supra*; *Walls v. Commissioner*, *supra*; *Maddrix v. Commissioner*, 83 T.C. 613, 620–626 (1984).[8] In all of these cases, the taxpayers satisfied their obligation to pay an advance minimum royalty by executing an agreement where

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mineral is produced (*i.e.*, when a mineral product first exists). However, in the case of advanced mineral royalties paid or accrued in connection with mineral property as a result of a minimum royalty provision, the payor, at his option, may instead treat the advanced royalties as deductions from gross income for the year in which the advanced royalties are paid or accrued. See section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For purposes of this paragraph, a minimum royalty provision requires that a substantially uniform amount of royalties be paid at least annually either over the life of the lease or for a period of at least 20 years, in the absence of mineral production requiring payment of aggregate royalties in a greater amount. For purposes of the preceding sentence, in the case of a lease which is subject to renewal or extension, the period for which it can be renewed or extended shall be treated as part of the term of the original lease."* * *

[7]See note 3 *supra* for the differences between the amounts of coal to be mined before payment would be due.

[8]This Court, on numerous occasions, has held that the contingent nature of nonrecourse notes does not establish an enforceable requirement that substantially uniform minimum royalties be paid annually, regardless of annual production. *Wing v. Commissioner*, *supra*; *Surloff v. Commissioner*, *supra*; *Maddrix v. Commissioner*, 83 T.C. 613, 620–626 (1984); *Vastola v. Commissioner*, 84 T.C. 969, 975–976 (1985).

e taxpayer transferred some cash and signed a nonrecourse omissory note in the balance amount payable generally in years. The Government argued in these cases that the ovision at issue did not constitute a "minimum royalty ovision" because it allowed the taxpayer to defer the balance the royalty for some years through the execution of a nrecourse note, rather than requiring payment each year. e also *Vastola v. Commissioner*, 84 T.C. 969 (1985).

In adopting the Government's position that the provision in estion did not constitute a valid "minimum royalty provi-on," we stated in *Wing v. Commissioner*, *supra* at 40–41, that:

> qualify for the deduction, the petitioner must meet the terms of the gulation, which sets out that a minimum royalty provision must *require* yment at least annually. That the note may in fact be paid at some later te is not sufficient to establish the existence of such a requirement.

Our holding and logic in *Wing*, *Maddrix*, and *Vastola* are uarely on point and clearly apply to the instant case. The ddendum to mining lease" executed by the parties autho-zed the payment of all future annual minimum royalties by eans of nonrecourse notes. The notes were due in subsequent ars and payment was required only if coal in excess of the itial 60,000 tons was produced.[9] Irrespective of the likelihood the eventual satisfaction of such notes, the "addendum to ining lease" permitted deferral of the minimum annual yalties provided for in the "mining lease" so that payment as not required to be made at least annually. Consequently, e "payments" made by petitioners in 1977 and 1978 were not ade pursuant to a valid "minimum royalty provision" in cordance with valid section 1.612–3(b)(3), Income Tax Regs. Petitioners do not present any new arguments. Moreover, no tempt was made to factually or legally distinguish their case om the clear and established precedent in this area. This se involves the same Wyoming & Western Coal Reserves, c., that has been involved in several prior adjudications of is Court. Petitioners and their counsel consumed this Court's ne supposedly to introduce evidence as to petitioners' intent. et petitioners and their counsel do not argue on brief that titioners' intent can and does distinguish this case from the

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[9] With respect to petitioners Arthur K. Lund and Colleen M. Lund, payment was required only if l in excess of 120,000 tons was produced.

clear precedent in the area. In fact, the briefs submitted in this case are substantially identical to other briefs and memoranda filed with this Court dealing with Wyoming & Western Coal Reserves, Inc., and Coal & Minerals Leasing & Development Corp.[10] The similarities in petitioners' briefs are too numerous to be a coincidence. Regardless of the reasons why the briefs are substantially identical, this case has consumed respondent's and this Court's time. In addition, petitioners raise these same arguments in cases appealable to the Ninth Circuit which has already decided these issues. *Redhouse v. Commissioner*, 728 F.2d 1249 (9th Cir. 1984).

The next issue we must decide is whether damages shall be awarded under section 6673.[11] The *same* material facts presented by petitioners herein have previously been adjudicated by this Court in *Ward v. Commissioner*, *supra*; *Thompson v. Commissioner*, *supra*; and *Walls v. Commissioner*, *supra*. All of these cases concern tax shelters involving the same Wyoming & Western Coal Reserves, Inc., and were published before the trial and submission of these cases for our consideration. Petitioners and their counsel repetitiously raise the same issues already decided in *Wendland v. Commissioner*, *supra*; *Redhouse v. Commissioner*, *supra*; *Wing v. Commissioner*, *supra*; *Thompson v. Commissioner*, *supra*; and *Walls v. Commissioner*, *supra*. See also *Vastola v. Commissioner*, *supra*. While *Wendland v. Commissioner*, *supra*, was appealed to the 11th Circuit Court of Appeals, the 11th Circuit affirmed on August 21, 1984, which was before the date set for trial for any of these consolidated cases. Petitioners were given adequate notice well in advance of trial regarding similar cases involving the same facts and were provided notice of the law of the circuit to which their cases are appealable. Notwithstanding the well established precedent, petitioners have presented

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[10] In many tax shelters similar to this one, Joseph R. Laird, Jr., attorney at law, who is also president of WW, encloses a letter in the documents stating that he personally guarantees that legal representation will be provided to "investors" such as petitioners in this case in the event that the Internal Revenue Service attacks the projected tax treatment.

[11] SEC. 6673. DAMAGES ASSESSABLE FOR INSTITUTING PROCEEDINGS BEFORE THE TAX COURT PRIMARILY FOR DELAY, ETC.

Whenever it appears to the Tax Court that proceedings before it have been instituted or maintained by the taxpayer primarily for delay or that the taxpayer's position in such proceedings is frivolous or groundless, damages in an amount not in excess of $5,000 shall be awarded to the United States by the Tax Court in its decision. Damages so awarded shall be assessed at the same time as the deficiency and shall be paid upon notice and demand from the Secretary and shall be collected as a part of the tax.

their cases with no new or meritorious arguments to distinguish their cases from the previously litigated and existing precedent. In fact, the same prepackaged and preprinted forms employed in the prior cases were used here, as well as the briefs that appear prepackaged. The only difference in these cases is the amount of money "invested" and, more importantly, the amount of deductions claimed.

It is apparent from the facts of this case that petitioners were involved in an abusive tax shelter. Essentially, petitioners have claimed 4-to-1 "leveraged" deductions based upon nonrecourse financing which is payable out of production, if any. This is tantamount to purchasing a $4 tax deduction with every dollar paid to a promoter who provides a facade of a legitimate enterprise in an attempt to satisfy the form of the transaction. This type of arrangement frustrates the congressional purpose inherent in the deductions that we here disallow to petitioners. In spite of numerous Court opinions squarely on point, petitioners have forced an already overburdened Court and tax system to unnecessarily consume precious resources. Petitioners, and others who participate in specious tax strategems, must accept the consequences of their actions.

The conferees in discussing damages under section 6673 stated "The conferees believe that, with this amendment, the Congress has given the Tax Court sufficient tools to manage its docket, and that the responsibility for effectively managing that docket and reducing the backlog now lies with the Tax Court." H. Rept. 98–861 (Conf.) (1984), 1984–3 C.B. (Vol. 2) 1, 239. Congress also noted with approval the steps that this Court has taken in the tax shelter and tax protester areas and stated that this "Court should take further action in these two areas, as well as to assert, without hesitancy in appropriate instances, the penalties that the Congress has provided." H. Rept. 98–861, *supra* at 239.

We also have stated in *Elliott v. Commissioner*, 84 T.C. 227, 248 (1985), that "At some point, the arguments in these highly leveraged tax avoidance (or evasion) schemes must be regarded as 'frivolous or groundless,' " citing section 6673. We have frequently found that cases based upon meritless contentions and stale arguments are burdensome both on this Court and upon society as a whole. See *Abrams v. Commissioner*, 82 T.C.

403 (1984). The time spent upon this case has delayed other cases of merit which could have provided new precedents to the tax system. Petitioners' brief, much like their abusive tax shelter "investment," was merely a prepackaged, pro forma presentation.

Upon review of this record, we find that petitioners' positions are frivolous and groundless and that this proceeding was instituted and maintained primarily for delay. We admonish other petitioners and their counsel not to maintain frivolous proceedings before this Court or to maintain them primarily for delay. On respondent's motions, we award damages to the United States under section 6673 in the maximum amount of $5,000 as to petitioners in docket Nos. 12511–81 and 10961–82 and $5,000 as to petitioners in docket No. 12512–81.

To reflect the foregoing,

Appropriate orders will be entered on the respondent's motions for damages, and decisions will be entered for the respondent.

JAMES P. THOMAS AND MARY LOU THOMAS, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 29942–81. Filed June 4, 1985.

Petitioner, as a participant in the Wise County Mining Program, claimed a deduction for "mining development costs," "operating management fees," and "professional fees." *Held*: Petitioner has failed to carry his burden of proving that the Wise County Mining Program was organized and operated with the primary and predominant objective of realizing an economic profit. Therefore, petitioner is not entitled to deduct under sec. 616(a), I.R.C. 1954, his allocable share of "mining development costs." *Held, further*, petitioner is not entitled to deduct his allocable share of "operating management fees." *Held, further*,

petitioner is not entitled to deduct his allocable share of "professional fees."

Elliot I. Miller and *Richard S. Kestenbaum*, for the petitioners.

Joseph A. Maselli, Patricia A. Donahue, and *Michael Goldbas*, for the respondent.

STERRETT, *Chief Judge*: By notice of deficiency dated September 25, 1981, respondent determined a deficiency of $37,411 in petitioners' 1978 Federal income tax.[1] The ultimate issue for decision is the amount, if any, that petitioners are entitled to deduct in 1978 for "mining development costs," "operating management fees," and "professional fees."

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts, together with the exhibits attached thereto, is incorporated herein by this reference.

At the time they filed their petition herein, petitioners, who are husband and wife, resided at 2309 Jefferson Street, Bluefield, West Virginia. Petitioners filed their Federal income tax return for the year in question with the Office of Internal Revenue in Memphis, Tennessee.

The determined deficiency in this case arises out of petitioner James P. Thomas's participation in the Wise County Mining Program (hereinafter sometimes referred to as the program), which was organized and operated for the avowed purpose of exploiting certain coal rights. When used hereinafter, "petitioner" will refer to James P. Thomas.

The Wise County Mining Program was organized primarily through the efforts of Samuel L. Winer, who actively engages in the structuring of various types of tax-sheltered investments, promising as high as 6-to-1 writeoffs. Winer first became involved in coal mining ventures in 1976, when he

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[1] The parties in the following docketed cases have agreed to be bound by the final decision in this case: Jerry D. Legg and Carolyn Legg, docket No. 30322-81; Kenneth D. Bird and Ronnette M. Bird, docket No. 30597-81; James E. Gooding and Mary Lou Gooding, docket No. 7674-82; Frank N. Fleischer and Barbara C. Fleischer, docket No. 11208-82; Ralph M. Stephan and Marilyn L. Stephan, docket No. 25829-82; Myron C. Abramson, docket No. 32913-83; and Louis L. Witkin and Ann Witkin, docket No. 1777-84.

joined Knox County Partners, Ltd., as a general partner.[2] In 1977, Winer formed Investors Coal Corp. (Investors Coal), and through that corporation, he organized and managed several coal mining ventures, including Investors Mining Programs 77–1 through 77–5[3] and Investors Mining 78–1. Winer served as president of Investors Coal, and he and his wife were the sole shareholders and officers of the corporation.

In late October 1978, Winer was contacted by his attorney in Miami, Florida—Ronald Fieldstone, of Levine & Fieldstone—about developing the coal program that eventually became known as the Wise County Mining Program. Fieldstone had represented Winer in connection with a different coal mining venture organized earlier in the year. Fieldstone invited Winer to his office to meet with Bill Humphreys, a miner from Norton, Virginia. At that meeting, Winer told Humphreys that he might be interested in negotiating a coal venture if Humphreys would perform services with respect to the property on a turnkey basis. After Winer met Humphreys he telephoned a reference at the Bank of Pound, Virginia, who informed him that Bill Humphreys and his brother, Jim Humphreys, had "a big mountain" and did extensive mining.

At the end of October or the beginning of November 1978, Winer traveled to Norton, Virginia, to meet with Bill Humphreys and his brother, Jim Humphreys, at the offices of Humphreys Enterprises, Inc. (Humphreys Enterprises), a production and management company primarily involved in strip mining. Jim Humphreys had joined his brother's business on a full-time basis in 1977 in order to handle administrative matters for Humphreys Enterprises. Prior to that time, Jim Humphreys' background was in the field of education.

After touring the offices of Humphreys Enterprises, Winer and the Humphreyses turned to a discussion of what sort of mineral leases the Humphreyses had to offer. The Humphreyses informed Winer that they had recently acquired the deep mining rights to the Clintwood seam on what was known as the Amburgey Hollow property in Wise County, Virginia, and had formed Shelton Coal Corp. (Shelton Coal) to develop the property. Shelton Coal was one-third owned by each Bill

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[2] See *Seaman v. Commissioner*, 84 T.C. 564 (1985).

[3] See *Maddrix v. Commissioner*, 85 T.C. 613 (1984), on appeal (11th Cir., Mar. 12, 1985); *Estate of Blay v. Commissioner*, T.C. Memo. 1984–565.

Humphreys, Jim Humphreys, and one Douglas Shelton. These gentlemen were the officers and directors of the corporation, as well. Winer asked how much capital would be needed for a turnkey development of the mine and was informed that development of the mine, over approximately a 10-year period, would cost between $2,500,000 and $3 million. According to the Humphreyses, approximately $700,000 would be required as initial funding. An understanding was reached that, if a transaction between the parties in fact was consummated, the investors would put up approximately $700,000 in cash and execute nonrecourse promissory notes secured by the investors' interests in the mineral lease as "payment" for the deferred portion of mining development costs.

At this point, it was contemplated that Shelton Coal would be engaged to perform the actual mining operations and would be the obligee under the nonrecourse notes. The parties, at Winer's suggestion, agreed generally that, in the event Shelton Coal failed to mine sufficient coal to enable the investors to amortize their nonrecourse notes, the corporation would pay to the investors a sum that would be adequate to compensate for the shortfall in mining and also adequate to enable the investors to satisfy their notes. At some later date, Winer and the Humphreyses agreed that Shelton Coal would not pay cash to the investors in satisfaction of any default in the minimum mining commitment; rather, such a default would be evidenced by "offsets" or journal entries reducing the investors' notes.

Before leaving Norton, Virginia, Winer accompanied Bill Humphreys on a visit to various mine sites operated or supervised by Humphreys Enterprises. In addition, he flew over the Amburgey Hollow property in a helicopter. Winer did not see any mines operated or supervised by Douglas Shelton, but he was given a copy of Shelton's résumé. Winer left Norton, Virginia, with the understanding that he would send a mining engineer to inspect the Clintwood seam on the Amburgey Hollow property.

The Amburgey Hollow property, which consisted of approximately 169 acres, was acquired in fee in 1971 by Greater Wise, Inc., a leaseholding company owned and controlled by the Humphreyses. The property was acquired in conjunction with an overall acquisition of 126 tracts of property and the

buildings thereon for $400,000 in cash. The acquisition consisted of about 7,000 to 9,000 acres of property. In 1972, Greater Wise, Inc., leased all the property, with the exception of 1,000 acres, to Paramont Mining Corp. (Paramont). Pursuant to the lease, Paramont obtained both the surface and deep mining rights to the coal located on the leased property. On November 14, 1978, an agreement was entered between Humphreys Enterprises and Paramont, whereby Paramont authorized Humphreys Enterprises to deep mine the Clintwood seam of coal. In exchange, Paramont received mineral rights to another piece of property known as the Hagan Estate. Pursuant to the November 14, 1978, agreement, Humphreys Enterprises agreed to sell all coal mined from the Clintwood seam to Paramont for $23.50 per clean ton of coal, subject to upward or downward price adjustments. In the event that Paramont was unable to purchase the coal produced, then Humphreys Enterprises could sell the coal to third parties and pay Paramont 10 percent of the sales price. Paramont retained the surface mining rights to the Clintwood seam and, in fact, was mining the seam at the time Winer visited Humphreys Enterprises in late 1978, and continued doing so for a number of years thereafter.

The Amburgey Hollow tract is divided into two distinct areas separated by a narrow corridor or passageway. The southern portion of the property is much smaller than the northern portion. It was contemplated that mine development would commence on the smaller southern portion of the tract and then proceed through the passageway to the larger northern portion of the property.

Shortly after his trip to Norton, Virginia, Winer engaged Eric Roberts, a mining engineer, to prepare an engineering report on the Amburgey Hollow property. Roberts had evaluated coal property for Winer earlier in the year in connection with another transaction. The report was to consist of a reserve evaluation and a discussion of the quality of the coal, operating and development costs, and marketing. Roberts visited Humphreys Enterprises and inspected the proposed mine site on November 8, 1978. Jim Humphreys transported Roberts to a "highwall" where there had been previous surface mining operations and where it was proposed that mining would begin. Roberts measured the seam at 90 inches in height

at five locations along the highwall.[4] He observed an average of about a 5-inch shale parting in the seam. Roberts walked approximately one-half mile around the outcrop and made other inspections of the coal seam where it was outcropping. Roberts then flew around the mountain in a helicopter and observed that the seam was continuous through the mountain. From the helicopter Roberts could not observe the thickness of any parting in the seam.

After Roberts completed this inspection, he was transported back to the Humphreyses offices where he examined maps, surveys, and other data relating to the Amburgey Hollow property. The maps examined showed some rather extensive old mine works and some large areas designated "robbed" and revealed that there was a parting in the seam of up to 12 inches. Roberts failed to examine a map that had been revised on January 1, 1978, and that revealed extensive shale parting throughout the main portion of the coal seam. There were no core drillings when Roberts examined the property, and Roberts himself performed no core drillings.

Roberts rendered his written report on the proposed development of an underground mine on the Amburgey Hollow property in December 1978. That report contained a discussion of reserves, coal quality, a proposed mining plan, and development, production, and operating costs. Roberts concluded that, based on a 75-percent recovery rate, reserves amounted to 1,700,000 tons. He noted that a 14 C.M. Joy continuous miner would mine the coal and would take all the seam, including the "middle man" parting, and that the coal would be upgraded in a preparation plant. Roberts further noted that the shape of the lease would dictate several underground development reorientations over the life of the mine, but that this type of development would not affect "the projected production which should average at least 500 tons per day or 120,000 tons per year of salable coal." In Roberts' opinion, $2,600,000 was a reasonable amount to be charged for the development of the proposed mining operation. In estimating mining production costs of $13.65 per ton of clean coal, Roberts

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[4] In his written report, Roberts actually indicated that he measured the seam at 90 inches in height at five "openings" into the seam along the highwall. At trial, however, Roberts admitted that the use of the word "openings" was a "misnomer," as there were no openings along the highwall.

assumed, inter alia, that continuous miner productivity would be 500 tons per shift; that the mine would produce on only one shift per day; that there would be production on 240 days per year; and that yearly production would amount to 120,000 tons of raw coal per year and 90,000 tons of salable coal. Roberts estimated overall operating costs per ton of clean coal as follows:

Minesite production cost	$13.65
Haulage to wash plant	1.50
Interest and depreciation on equipment	3.00
Royalty	2.50
Contractor's profit	1.85
Return to investors for payments of development cost, etc.	2.50
Selling price to preparation plant	25.00

Roberts used the $25 selling price because the Humphreyses told him that was the price they would receive from the Paramont tipple. Roberts did not independently verify that figure.

According to Roberts, he used a 75-percent recovery rate in computing reserves to compensate for barrier pillars that would need to be left around the old mine works revealed on the maps he examined. Roberts also assumed a 25-percent reject rate to compensate for parting in the seam. Roberts' calculations did not take into account the effect of Paramont's operations. While visiting the Amburgey Hollow property, Roberts "mentally noted" that, should the need for backup reserves arise, there were large reserves on the surrounding areas that were under the control of the Humphreyses. In this connection, however, Roberts did not inquire with respect to the legal status of those reserves and was unaware of the property rights to other parcels of property surrounding the Amburgey Hollow property.

At some later date, Paramont prepared a reserve study of the Clintwood seam based on a core drilling program. Paramont's study determined total tonnage in place of 2,254,583 tons. Paramont's study of coal reserves in place was computed over 207.08 acres and revealed an average seam characteristic of 39 inches coal, 24 inches shale, and 36 inches coal. Core drilling studies performed on behalf of Paramont indicated a parting in the seam ranging from approximately 20 inches to 5½ feet in thickness.

By letter to potential investors dated November 28, 1978, Winer announced that Investors Coal had agreed to become the operating manager in a coal mining program in Wise County, Virginia. In his letter, Winer broke down the projected tax benefits for 1978 as follows:

($74,340)	Taxable loss
37,170	Tax savings (50-percent bracket)
25,000	Investment (1978)
12,170	After-tax cash flow

By a private offering memorandum dated November 30, 1978, Investors Coal, as "operating manager," offered for sale 36½ working interests in the Wise County Mining Program at $25,000 cash per working interest. The offering memorandum stated that, in addition, Winer, as president of Investors Coal, would purchase a one-half working interest for $500, and the principals of the sublessor (Humphreys Enterprises) and of the contract miner (Shelton Coal) would purchase a minimum of eight working interests.

The offering memorandum indicated that the total proceeds received by the Program, consisting of $912,500 in cash paid by the investors, $1,930,000 in nonrecourse notes executed by the investors, and $500 in cash paid by Winer, would be used as follows:

$695,000	Cash to be paid to the contract miner for development costs
1,930,000	Nonrecourse notes to be paid to the contract miner for development costs
5,000	Rental payment to sublessor
30,500	Organizational expenses, legal fees, accounting fees, and printing fees
80,750	Initial management fee to be paid to the operating manager
10,500	Working capital for the program
91,250	Fees to be paid to selling brokers, offeree representatives, and other advisers

The offering memorandum summarized the estimated 1978 tax effects per working interest as follows:

Mining development costs	$71,150
Other deductible expenses	3,000
Approximate total deductions	74,150

Per unit cash investment	$25,000
Approximate ratio of per unit deductions to per unit investment	3.00 to 1

Investors were informed of a seemingly exhaustive list of potential risks inherent in the investment. It was noted that the sublessor had committed itself to provide, at its sole expense, additional coal-bearing acreage to the program to the extent that commercially merchantable and minable coal on and under the property did not equal 1,500,000 tons; however, it was further noted that there could be no assurance that the sublessor actually would be able to provide such additional property. With respect to market prices and the sale of coal, in general, it was noted that the operating manager had been advised that the program could expect to receive an average price of $25 per ton of coal mined, unwashed, and delivered to the washing plant. Nevertheless, investors were warned that coal prices were subject to wide fluctuations. Furthermore, it was contemplated that the contract miner would have the right, if an investor so elected, to serve as the investor's sales agent for a 1-year renewable period. Given that the sales agent was not to be authorized by the investors to enter into long-term contracts for the sale of coal, it was noted that an investor might have difficulty in taking advantage of certain favorable long-term contracts for the sale of his respective share of the coal. Another significant risk noted was that there could be no assurance that the contract miner would adequately develop and mine the property. In this connection, investors were cautioned that a cessation of development and mining activities for any extended period could leave the program with insufficient funds to conduct further operations. Other risks noted, included, inter alia, the fact that the operating manager had limited previous experience in the operation of a coal mining business and that conflicts of interest between the program and the sublessor or contract miner currently existed and would continue to exist in the future.

Although the offering memorandum devoted some discussion to the proposed operations of the program and the background of the coal mining industry in general, the focal point of the offering memorandum unquestionably was on the potential tax consequences to investors as evidenced by the 53-page tax opinion prepared by Fieldstone's law firm and

attached to the memorandum and a rather thorough summary of the opinion contained in the actual body of the offering memorandum. The memorandum cautioned that, since the IRS was challenging "tax sheltered investments," prospective investors should take into consideration the increased audit potential. In addition, it disclosed that the Service currently was auditing the tax returns of investors in other programs conducted by companies affiliated with Investors Coal.

An examination of the tax opinion reveals that a primary concern was in determining the status of the program for Federal income tax purposes. The tax opinion concluded that the program should be treated as a partnership and not as an association taxable as a corporation for Federal income tax purposes. However, the opinion further concluded that the program should be classified as an organization that qualified to elect under section 761(a), I.R.C. 1954, to be excluded from the application of subchapter K, in which event neither the program nor the investors would be subject to the special "at risk" provisions of section 704(d) as in effect for the 1978 taxable year.

In addition to the tax opinion, various other exhibits were attached to the offering memorandum. Those exhibits included a copy of the engineering report prepared by Roberts,[5] a joint operating agreement, a sublease agreement, a mining services agreement, a mining development agreement, a sales agreement, a chart of financial projections, and execution documents, such as the subscription agreement, statements of the section 761(a) election, and a nonrecourse promissory note.

Pursuant to the joint operating agreement, which was to be executed by each investor in the Wise County Mining Program and Investors Coal, as operating manager, Investors Coal was vested with the authority to act as agent on behalf of each investor to carry out the ministerial and administrative duties in connection with the program. However, the operating manager was not authorized to perform certain specified acts without the consent of two-thirds of the working interests. The investors reserved the right to their pro rata shares of the coal

[5] The copy of Roberts' report that was attached to the offering memorandum contained essentially the same information as his originally prepared report, except that the report attached to the offering memorandum contained an estimated higher production cost and a higher return to investors and did not take into account contractor's profit.

mined from the property and the right personally to sell or direct the sale thereof for their respective benefits. As compensation for services rendered, the operating manager was to receive $80,750 as an "initial management fee"; $0.50 per ton of coal mined and removed from the property as an administrative fee; 10 percent of the net sales proceeds in excess of $25 per ton; and reimbursement for its out-of-pocket expenses incurred in the performance of its services. In addition, the operating manager was authorized to allocate $0.15 per ton of the net sales proceeds due each investor as a reserve toward legal, accounting, insurance, out-of-pocket, and other miscellaneous expenses incurred in connection with the operation of the program. The joint operating agreement further provided that Winer, as president of the operating manager, would purchase one-half working interest for $500. The operating manager agreed to pay each investor, at least annually, the net proceeds from the sale of each investor's pro rata share of coal after all required cash obligations of each investor had been paid. The operating manager could be removed by the vote of investors owning at least 66⅔ percent of the working interests. By executing the joint operating agreement, each investor agreed to elect under section 761(a) to exclude the partnership from the application of subchapter K.

The sublease agreement was to be executed by Humphreys Enterprises, as sublessor, and each investor, as sublessee. Pursuant to the sublease agreement, the investors acquired the right to deep mine the property described in the sublease in exchange for an initial fee of $5,000 and a tonnage royalty of $2.50 per ton of merchantable coal mined, removed, and sold from the property. Under the terms of the sublease agreement, the sublessor and Shelton Coal warranted that to the extent that there were not commercially minable deep coal reserves on the leased property of at least 1,500,000 tons, they would, at their sole expense, contribute additional coal-bearing acreage of equal quality to compensate for such deficiency. In addition, in the event that the property could not be exploited because of another party's superior property rights or a deficit in title, the sublessor agreed to substitute other coal leases containing substantially equivalent recoverable coal reserves on terms no more onerous than the terms of the lease. The sublease

agreement contained the following provision (hereinafter referred to as the "force majeure provision"):

> FORCE MAJEURE: The failure of either party to perform its obligations under this Agreement for reasons beyond their resepective [sic] controls after using every reasonable effort to cure and remedy any problems or consequence thereof as the result of Acts of God, acts of the public enemy, insurrection, riots, strikes, labor disputes, lock-outs, slow-downs, fires, explosions, floods, shortage of railroad cars, inability to obtain bonds and permits for reasons beyond the control of the Sublessees (e.g. a state policy of non-issuance), interruptions of transportation, embargoes, orders or acts of military or civil authority or adverse weather conditions that render hazardous the performance of the operations contemplated hereby or unavailability of equipment or replacement parts shall not constitute a breach of this Agreement or a violation of its terms and conditions. Also included shall be the unavailability of commercially merchantable and mineable coal on the Property pursuant to the representations of the Sublessor herein and the inability to obtain state and federal mining permits. The party determining the force majeure shall give notice to the other party following its determination that such conditions [sic] exists, stating specifically the date of commencement of the condition, the basis for the condition, and its anticipated duration.

The mining services agreement was to be executed by Shelton Coal, as the contract miner, and each investor. Pursuant to the terms of the mining services agreement, the contract miner was given the sole and exclusive right to mine all merchantable coal from the leased property. The investors, in return, agreed to pay the contract miner $17.95 per ton for coal mined and delivered to the investors or their designee plus 70 percent of the net sales proceeds in excess of $25 per ton received by the investors on the sale of the coal. The mining costs were subject to escalation in the event of, for example, any increase in the proven direct cost of mining. However, in no event were the mining costs to be escalated by any amount in excess of any per-ton increase received by an investor in connection with the sale of coal. The mining services contract contained a force majeure provision that was substantially identical to the one contained in the sublease agreement. Subject to the occurrence of force majeure, the contract miner agreed to mine no less than 120,000 tons of merchantable coal in each year of the agreement. (This provision sometimes hereinafter will be referred to as the minimum mining commitment.) The contract miner agreed that, if it failed to meet its minimum mining commitment in

any year, it would pay the program "liquidated damages" in an amount equal to $2.40 per ton multiplied by the difference between the 120,000 tons guarantee and the actual number of tons delivered in such year. The investors were given a number of remedies in the event of a default by the contract miner, including the right to foreclose on their security interests in equipment being used by the contract miner and the right to utilize such equipment.

A mining development agreement also was to be executed by Shelton Coal, as contract miner, and each investor. Under the terms of the mining development agreement, the contract miner agreed to develop the property, on a turnkey basis, in a manner that would enable the investors to deep mine the property at a rate of 120,000 tons per year, subject to the contingency of force majeure and prevailing economic circumstances. The term of the agreement was to continue until the contract miner completed development of the property or other property contributed to the investors by the sublessor. On the effective date of the agreement, the investors were to pay the contract miner $2,625,000 as full and complete payment for the development of the property, $695,000 of which was to be paid in cash and $1,930,000 of which was to be represented by nonrecourse promissory notes. The occurrence of force majeure, which was defined in the same manner as in the sublease agreement and the mining services agreement, would extend the maturity date of the installment payments due under the nonrecourse notes. The investors' remedies upon default by the contract miner included the right to foreclose on their security interest in the equipment being used by the contract miner, the right to utilize such equipment, and the right to sue for damages.

The sales agreement was to be executed by Shelton Coal, as sales agent, and by each investor. Pursuant to the terms of the sales agreement, each investor authorized the sales agent to arrange for the sale of his respective pro rata share of the coal mined from the property. No contract or commitment for the sale of coal could extend for a period in excess of 1 year. Although the sales agent was precluded from arranging long-term contracts, each investor was entitled to enter into long-term contracts for his own account. The sales agent was authorized and directed to pay from the coal sales proceeds

each investor's share of costs and expenses in the program. The sales agent would receive a commission of $0.25 per ton from each investor for selling the investor's share of the coal.

The financial projections attached to the offering memorandum were based on assumptions and estimates of the operating manager, including the assumption that the program would be able to mine and sell 120,000 tons of coal per year until the exhaustion of all recoverable reserves and the assumption of a $25-per-ton selling price. The projections were reviewed by Price Waterhouse & Co., which specifically declined to express an opinion on the fairness of the projections. The offering memorandum cautioned potential investors not to rely on the projections in considering whether to purchase working interests.

Petitioner purchased one working interest in the Wise County Mining Program by check dated December 4, 1978, and made payable to Investors Coal. On December 11, 1978, petitioner executed a copy of the joint operating agreement, the sublease, the mining services agreement, the mining development agreement, the sales agreement, and a subscription agreement. In addition, petitioner signed a statement electing, pursuant to section 761(a), to exclude the Wise County Mining Program from the application of the provisions of subchapter K and agreeing to use the accrual method of accounting for reporting taxable income or loss from his working interest in the program. On December 11, 1978, petitioner also executed a nonnegotiable, nonrecourse promissory note in the amount of $52,162 payable to Shelton Coal, as contract miner. The nonrecourse note represented petitioner's share of the deferred "mining development" expenses. By its terms, the note bore interest at the rate of 6 percent per annum. The note was payable monthly in arrears in principal installments of $362.23, together with accrued interest. The note was secured by petitioner's fractional undivided interest in the sublease.

As did petitioner, each of the other investors in the Wise County Mining Program signed the documents relating to his own investment at some time during the month of December 1978 and made his respective capital contribution to the program by paying in full his cash portion of the "mining

development" costs and by signing a nonrecourse promissory note for the deferred portion.[6]

On December 28, 1978, there was a formal closing of the transaction at the offices of Levine & Fieldstone, at which time the cash portion of the "mining development" cost and the nonrecourse, nonnegotiable promissory notes representing the deferred portion of that cost were delivered to Shelton Coal, and the $5,000 initial rental for the mineral lease was paid to Humphreys Enterprises. On the same date Shelton Coal delivered a document to Winer, as president of Investors Coal, wherein the former corporation agreed that in consideration for the $695,000 in cash plus the $1,930,000 in nonrecourse notes received from the investors in the Wise County Mining Program, Shelton Coal would "provide, in part, from such funds, amounts for working capital and equipment and/or purchases in order to enable itself * * * to expeditiously develop the coal property and mine a sufficient amount of coal to meet the required payments under the Mining Services and Mining Development Agreements." Shelton Coal also delivered a list of equipment that it had purchased or was planning to purchase in order to develop or mine the property.

On February 6, 1979, Winer informed the investors that the offering memorandum was mistaken when it indicated that Investors Coal would purchase a one-half working interest and that the corporation had actually purchased one working interest.

Incidental to the development of the mine, Shelton Coal began extracting and selling coal from the Amburgey Hollow property in January 1979. Investors Coal received and then distributed to investors the first distribution of coal sales proceeds in about the third week of January 1979. Subsequently, regular distributions of coal sales proceeds were made through July 1979. The distributions to investors were accompanied by written communications from Winer and so-called "Coal Sales Settlement Sheets." Each coal sales settlement sheet reflected, for the period in question, the coal sales proceeds and the deductions therefrom allocable to the particular investor. The items deductible from the gross proceeds in arriving at the amount of proceeds distributable to each

[6]The check of one investor actually was dated Nov. 7, 1978.

investor included mining costs, sales commissions, royalty expenses, management fees, administrative expenses, and amounts necessary to retire the nonrecourse note held by Shelton Coal at the rate of $2.34 per ton.

Within a month after mining development commenced on the property, Shelton Coal began hitting old mine works. In fact, old mine works were hit on November 27, 1978, prior to the issuance of the offering memorandum and were again hit on December 8, 1978. By April 1979, Shelton Coal informed Winer that it was encountering old mine works and that the roof of the mine was beginning to shift. The corporation continued hitting old mine works during the succeeding weeks and by the last of July or the beginning of August the roof of the mine had shifted sufficiently to create a dangerous condition in the mine. Accordingly, Douglas Shelton of Shelton Coal contacted the Mine Safety and Health Administration (MSHA). MSHA thereafter inspected the mine and issued a closure order.

By letter dated August 13, 1979, Jim Humphreys informed Winer that Shelton Coal had exhausted all methods of getting through the old mine works, that the old mine maps were evidently inaccurate, and that the venture had been an "unfortunate experience." He further informed Winer that MSHA had issued a closure order with respect to the mine. Humphreys explained that the only other way to reach the coal was by entering the other side of the mountain. Since Paramount owned the strip mining rights to the property, which rights took precedence over the Program's deep mining rights, Humphreys stated that Shelton Coal was sending a separate letter invoking the force majeure provision in the mining services agreement.

When Winer learned of the closure of the mine he contacted Roberts and requested that he inspect the mine and review the closure order. Roberts concluded that uncharted extensive old mine workings and the thickness of the dirt bands in the middle of the coal seam had made the mining of the Clintwood coal dangerous and unprofitable. In Roberts' opinion, MSHA was justified in issuing the closure order.

By letter to Winer dated August 14, 1979, Shelton Coal invoked its force majeure rights effective as of August 1, 1979. By letter dated October 8, 1979, Bill Humphreys, on behalf of

Shelton Coal, informed Winer that Humphreys Enterprises, in conjunction with Pardee Coal Co., Inc., had provided Shelton Coal with a substitute boundary of mineral situated in Pardee, Virginia. Humphreys proposed that the program accept this substitute property in order to "avoid the necessity (and possible adverse tax consequences) of an extended and indefinite force majeure." However, Humphreys informed Winer that, due to increased production costs, Shelton Coal could not continue to operate without receiving at least an additional $1.60 per ton for its services. Humphreys proposed that Shelton Coal would distribute $0.35 per ton to the Program, of which $0.15 could be used for administrative costs, $0.10 could be distributed to the operating manager, and $0.10 could be distributed to the investors.

By letter to Fieldstone dated October 17, 1979, Winer relayed Bill Humphreys' request for an additional $1.60 per ton for services and suggested that the mine be closed until prices improved. Winer requested Fieldstone's opinion with respect to whether "the closing of the mine temporarily [would] affect our tax position."

The program's investors were not informed of the old mine works encountered by Shelton Coal or the closing of the mine until November 1979. By letter dated November 8, 1979, Winer professed to bring the investors up to date on the status of the program. He explained that in the summer of 1979, Shelton Coal had informed him of the problems created by hitting old mine works and that the mine had been closed in August 1979. He further explained that Shelton Coal was operating a mine in Pardee, Virginia, on behalf of the program and that the program was negotiating with Shelton Coal with respect to the amount of income the program would receive from the Pardee mine. The remainder of the letter was devoted to promoting an oil and gas drilling program. The investors were urged to make a prompt decision on the drilling program "in order to take advantage of the tax deductions possible for this year."

Upon learning that the force majeure provision had been invoked and that operations were being moved to Pardee, Virginia, at least two investors, Wendall Jackson and Nelson Link, voiced objections to accepting less profit per ton. Jackson did not believe that there were adequate grounds for invoking

force majeure since he believed that it was common knowledge that old mine works existed in the area of the Clintwood seam and that any competent operator possessed the means by which to overcome the problem.

Winer eventually decided that, rather than risk a lawsuit by Jackson, who is an attorney, he would decline to accept the proposal that the Pardee mine site be used for the benefit of the program and, instead, would wait for Paramont to complete its strip mining activities before attempting to re-enter the Clintwood seam through the other side of the mountain.

Notwithstanding the invocation of force majeure, Shelton Coal informed Winer on January 6, 1980, that, although it could not afford to mine the Clintwood seam on the Amburgey Hollow property, it was looking for subcontractors; however, according to Shelton Coal, it was doubtful that any contractor would be willing to mine the coal pursuant to the terms of the mining services contract without receiving additional compensation from the investors.

In February 1980, Paramount informed Shelton Coal that its strip mining activities would continue until approximately January 1982.

During the next several months, Winer received a series of written communications from irritated investors who believed that force majeure had been invoked improperly and that Winer was not performing his administrative duties properly. Jackson was especially persistent. Time and again he wrote to Winer requesting information about the status of the Program. In addition, he asked for a list of the investors, but was unsuccessful in getting Winer to turn over such a list. Jackson wanted the names of the other investors so that they could take joint action aimed at firing Winer and bringing a suit against him. Eventually, disillusioned by what he characterized as Winer's "pleasant and innocuous" replies, Jackson filed suit against Winer, alleging failure of consideration, fraud, breach of contract, and violations of Securities and Exchange laws.[7]

Throughout this period of time Winer and the Humphreyses, directly or through their attorneys, engaged in a number of either verbal or written communications regarding the lack of

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[7] Winer countersued Jackson. At the time the trial was held herein, Jackson's suit was pending before a Federal District Court.

operations. However, Winer failed to take any sort of affirmative actions to enforce what he characterized as the investors' "turnkey rights" against Humphreys Enterprises and Shelton Coal.

It was not until April 1981 that Shelton Coal located a contractor, Triangle Mining, Inc. (Triangle Mining), that was willing to mine the Clintwood seam, albeit not in accordance with the terms of the original contracts executed by the investors. By letter dated April 24, 1981, Jim Humphreys, on behalf of Shelton Coal, advised Winer to accept the proposed terms of the contract with Triangle Mining, citing as one advantage of the arrangement that "The Program would be back in operation and possibly be in a better [position] to withstand an attack by the IRS on the tax treatment offered it." By letter dated May 4, 1981, Winer passed the news on to the investors, by stating that "We are in the process of offering a contract to an experienced mining company." In his letter, Winer enumerated some of the required changes in the original contract and the advantages inherent in offering a contract to Triangle Mining, including the advantage mentioned by Jim Humphreys.

By letter dated August 12, 1981, Winer solicited funds from the investors to be used for the purpose of retaining legal counsel to defend the investors' tax deductions. Several additional letters followed, urging reluctant investors to contribute to the "Legal Defense Fund" account. Winer advised that "Since we have had experience in doing this in other programs, your program can profit from this experience."

Notwithstanding the ongoing audits and the apparent ire of some of the investors involved in the programs masterminded by him, Winer continued to promote additional tax-sheltered investments of various types. The following excerpt is characteristic of the flavor of Winer's promotional literature:

> The Utopian situation would be if we could create *tax deductions* which are applied against *high* tax rates and *income* which is taxed at *low* tax rates. While this strategy has been considered "pie in the sky" in the past, there is being created today by the Reagan Administration a scenario which fits this situation. I'm referring to the Administration's individual tax reduction plan. The Reagan tax deduction proposal includes a significant reduction for the highest marginal tax bracket. Therefore, tax deductions created by oil and gas investment during 1981 will be taken against today's high marginal

tax rates (maximum 70%) while income from these same investments will be taxed at the proposed lower marginal tax rates (maximum 50%).

Triangle Mining started mining the property in September or October 1981 and apparently continued to act as subcontractor until sometime in June 1982, at which time it was forced to admit defeat due to water problems created by the method of mining being used, as well as market conditions. Throughout this period, Triangle Mining mined a rather insignificant amount of coal. The coal that was mined was so dirty that it was not readily salable. In the proposal to hire Triangle Mining, it was stated that the program would participate in profits when the selling price of coal reached $35 per ton. However, in his letter to investors, Winer stated that $1.95 per ton profit would be paid to investors when Triangle Mining began operations. The coal sales settlement sheets issued to investors in conjunction with the distributions of the coal sales proceeds from the coal mined by Triangle Mining indicate that the investors were paid $1.31 per ton of the coal sold.

The mining contract with Triangle Mining was evidently canceled in September or October 1982 for failure to meet minimum tonnage requirements, failure to follow an approved mining plan, failure to keep insurance in force and effect, failure to comply with applicable Federal and State laws, and failure to mine diligently in a workmanlike manner.

By letter dated October 4, 1982, Humphreys Enterprises informed Winer that it had exhausted all possibilities of finding a contractor to deep mine the property and that, from that point on, the responsibility for continuing operations and engaging a new contractor lay with Winer. Winer did not respond to this letter.

Paramont's strip mining operations on the property were completed substantially by the time the trial was held in this case. By letter to Winer dated November 8, 1983, the president of Paramont expressed interest in deep mining the Clintwood seam. However, Paramont was willing to pay only a 1-percent royalty to the program. In addition, because of the high reject rate due to excessive parting, Paramont proposed to mine only the top portion of the coal seam. No definite agreement had been reached with Paramont at the time the trial was held herein.

The following chart is a compilation of data for all coal sales of the program from its inception up through the time of trial:

Period	*Raw tonnage*	*Clean tonnage*	*Gross sales*	*Net proceeds to co-owners*	*Net proceeds to petitioner (or proceeds per working unit)*
1/ 1/79–1/15/79	2,728.50	1,718.61	$40,387.34	$2,251.38	$60.05
1/16/79–1/31/79	849.25	540.79	12,708.57	708.43	18.91
2/ 1/79–2/15/79	866.35	572.66	13,457.51	750.18	20.03
2/16/79–2/28/79	2,203.10	1,439.72	33,833.42	1,886.00	50.32
3/ 1/79–3/15/79	3,755.55	2,584.53	60,737.45	3,385.73	90.30
3/16/79–3/31/79	4,352.95	2,884.08	67,775.88	3,778.14	[8]100.76
4/ 1/79–4/30/79	[9]11,500.00	7,458.96	175,285.57	9,771.25	260.58
5/ 1/79–5/31/79	11,052.55	6,918.21	162,577.93	9,062.85	241.68
6/ 1/79–6/30/79	11,725.70	7,345.56	172,620.67	9,622.70	254.14
7/ 1/79–7/31/79	2,975.65	1,568.51	36,859.98	2,054.74	[10]55.53
10/16/81–10/31/81	142.85	[11]142.85	3,277.33	187.13	5.06
11/ 1/81–11/15/81	79.75	79.75	1,915.99	103.67	2.80
11/15/81–11/30/81	146.50	146.50	3,182.47	191.91	5.19
12/ 1/81–12/15/81	225.70	225.70	5,079.27	295.67	7.99

[8]There are no coal sales settlement sheets for this period. The $100.76 net proceeds figure is based on a letter written by Winer.

[9]The documents recording raw tonnage sold for this period are illegible in some respects, and we are able to determine only that raw tonnage sold approximated 11,500 tons.

[10]There are no coal sales settlement sheets reflecting net proceeds per working interest for the period July 1, 1979, through June 10, 1982. The figures appearing in the final column for this period equal one thirty-sevenths of the total net amount due to all investors.

[11]Evidently, the coal sold from October 16, 1981, through February 10, 1982, was sold on a raw-tonnage basis.

Period	Raw tonnage	Clean tonnage	Gross sales	Net proceeds to co-owners	Net proceeds to petitioner (or proceeds per working unit)
12/16/81–12/31/81	18.15	18.15	$408.46	$23.78	$0.64
1/ 1/82–1/10/82	57.35	57.35	1,353.22	75.13	2.03
1/26/82–2/10/82	185.20	185.20	?[12]	242.61	6.56
2/11/82–2/25/82	548.65	363.27	10,244.21	475.88	12.86
2/26/82–3/10/82	414.40	265.67	7,491.89	348.03	9.41
3/11/82–3/31/82	735.85	465.31	12,874.88	609.56	16.47
4/ 1/82–4/15/82	558.05	364.79	9,849.33	477.87	12.92
4/16/82–4/30/82	22.05	15.21	410.67	19.93	0.54
5/ 1/82–5/15/82	903.00	591.41	16,677.76	774.75	20.94
5/11/82–5/25/82	832.05	566.12	15,682.58	728.52	19.69
5/26/82–6/10/82	473.15	313.84	8,850.29	411.13	11.11
1/ 1/79–6/10/82	57,352.30	36,822.75	873,542.67	48,236.97	[13]1,286.51

John Hofmann, a CPA with Price Waterhouse & Co., was in charge of the program's accounting affairs. Specifically, he oversaw the program's election out of subchapter K, the preparation of the one and only Form 1065 filed by the program, and the preparation of information that was sent to each investor indicating the reporting positions to be taken on their Schedules C. The one and only Form 1065 filed by the program was filed for the calendar year 1978. Attached to the

[12]There are no coal sales settlement sheets reflecting gross sales proceeds for the period Jan. 26, 1982, through Feb. 10, 1982.

[13]Our calculations differ somewhat from respondent's calculations, as well as petitioner's calculations. However, having independently reviewed the relevant documents, we are unable to justify findings other than those set forth above.

Form 1065, which was left blank, was a statement of election pursuant to section 761(a)(2).

Petitioner, and apparently all of the other investors as well, elected the accrual method of reporting income and deductions attributable to their participation in the Wise County Mining Program. Items of income and expenses were allocated to the individual investors by reference to the number of units held by each investor. For the year in issue, 1978, the program had no income. The only items allocated to investors for that year were deduction items.

Petitioner was informed that he should report on his Schedule C for 1978 the following items:

Sales	
Deductions:	
Mine development costs	$70,498
Operating management fee	2,211
Professional fees	534
Net (loss) from operations	(73,243)

For the years 1979 through 1982, statements were prepared on behalf of the Wise County Mining Program indicating that petitioner received the following income or loss from his investment in the Wise County Mining Program:

Year	*Net income (loss)*
1979	$576.98
1980	no tax consequences
1981	163.51
1982	3,632.08

Petitioner's statement for 1980 informed him that due to the fact that force majeure was invoked for the year, there was no mining penalty to be taken into income. Petitioner's statements for 1981 and 1982 did reflect, as income, mining penalties in the respective amounts of $1,945.94 and $7,561.81. The "mining penalty income" was attributable to Shelton Coal's failure to satisfy its minimum mining commitment as set forth in the mining services agreement. Shelton Coal did not make any actual cash payment of the "liquidated damages" called for in the mining services agreement. Rather, Winer and the Humphreyses had agreed that the "liquidated damages" arising out of a breach of the minimum mining commitment would simply result in an offset against the

investors' nonrecourse promissory notes to Shelton Coal. The offsets were allegedly accomplished by way of journal entries, reducing the amounts of those notes. However, Shelton Coal's balance sheets and income statements through January 31, 1983, reflect the full amount of the original $1,930,000 nonrecourse promissory note received from the Program. The record herein fails to reveal that any of the investors ever made actual cash payments in reduction of the nonrecourse notes executed by them, other than indirect payments chargable against the coal sales proceeds attributable to them. In fact, as revealed in the tax opinion attached to the offering memorandum, it was contemplated from the outset that the notes would be paid out of the proceeds from coal sales.

On his Federal income tax returns for 1979 through 1982, petitioner took the following reporting positions with respect to his investment in the Wise County Mining Program:

Year	*Income (loss)*
1979	no income or loss
1980	no income or loss
1981	no income or loss
1982	$3,632

Respondent disallowed the $73,243 deduction claimed by petitioner on his 1978 Federal income tax return on a variety of grounds.

OPINION

Respondent advances a wide array of arguments in support of his disallowance of the deductions claimed by petitioner. His primary argument is that neither petitioner nor the Wise County Mining Program engaged in the coal mining activity with the primary and predominant objective of making a profit, and that, therefore, petitioner is not entitled to deduct for 1978 his allocable share of "mining development costs," "operating management fees," and "professional fees" under sections 162 and 616, I.R.C. 1954. Alternative arguments advanced by respondent include the following: (1) Petitioner is not entitled to a deduction for a mine development expenditure under section 616 because petitioner has failed to establish that an expenditure for "mine development" was paid or incurred in 1978; (2) even if petitioner is entitled to a

deduction for a mine development expenditure, such deduction should not include the nonrecourse note executed by petitioner, because that note was payable only in the event of successful mining operations and was therefore contingent; (3) the deduction for the mine development expenditure should be disallowed because it creates a material distortion of income; (4) the Wise County Mining Program was not entitled to be excluded from the application of subchapter K pursuant to a section 761(a) election because the partners' incomes could not be computed without computing partnership income; therefore, petitioner's distributive share of the partnership's loss is limited to his cash investment in the partnership pursuant to section 704(d);[14] and (5) petitioner is not entitled to deduct "operating management fees" and other "professional fees" because he failed to establish that these fees were ordinary and necessary business expenses under section 162(a).

Mining Development Costs

On his Schedule C attached to his 1978 Federal income tax return, petitioner claimed a deduction of $70,498 for "mine development costs." We begin our discussion of the deductibility of the "mine development costs" by addressing respondent's profit motive argument. Solely for purposes of our discussion of this argument, we will assume, without deciding, that petitioner has properly characterized the expenses as "mine development costs."

Section 616(a) provides, in part, that there shall be allowed as a deduction all expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit if paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed. See *Anderson v. Commissioner*, 83 T.C. 898 (1984).

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[14] Sec. 704(d), as in effect during the year in issue, provided, in part, as follows:

"A partner's distributive share of partnership loss * * * shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. * * * For purposes of this subsection, the adjusted basis of any partner's interest in the partnership shall not include any portion of any partnership liability with respect to which the partner has no personal liability. The preceding sentence shall not apply with respect to any activity to the extent that section 465 * * * applies, nor shall it apply to any partnership the principal activity of which is investing in real estate (other than mineral property)."

Sec. 465, as in effect during the year in issue, did not apply to a coal mining activity.

READEX FICHE

We agree with respondent that a deduction under section 616(a) is premised on a finding that the activity giving rise to the deduction is an activity engaged in with the primary purpose and objective of making a profit. Indeed, petitioner does not argue otherwise. The statute itself seems to contemplate the existence of a profit motive by requiring, as a condition to deductibility, that the ores and minerals have been shown to exist in "commercially marketable quantities." On numerous occasions we have held that other types of expenses incurred in connection with a coal mining activity are premised on a showing that the activity was engaged in with the primary and predominant objective of realizing a profit. See, e.g., *Seaman v. Commissioner*, 84 T.C. 564 (1985); *Surloff v. Commissioner*, 81 T.C. 210 (1983). As used in this context, "primary" means "of first importance" or "principally," and "profit" means economic profit, independent of tax savings. *Seaman v. Commissioner, supra* at 588; *Surloff v. Commissioner, supra* at 233. We know of no principled reason to apply a different test in the context of mine development expenses otherwise deductible under section 616(a).

The determination of whether the requisite objective exists is one of fact to be resolved on the basis of all the surrounding facts and circumstances. *Seaman v. Commissioner, supra* at 588; *Ramsay v. Commissioner*, 83 T.C. 793, 810 (1984); *Flowers v. Commissioner*, 80 T.C. 914, 931–932 (1983). The burden of proving the existence of the requisite objective rests with petitioner. Rule 142(a), Tax Court Rules of Practice and Procedure; *Golanty v. Commissioner*, 73 T.C. 411, 426 (1979), affd. without published opinion 647 F.2d 170 (9th Cir. 1981). Greater weight should be given to the objective facts than to mere statements of intent. Sec. 1.183-2(a), Income Tax Regs.; *Seaman v. Commissioner, supra* at 588; *Surloff v. Commissioner, supra* at 233.

In cases involving partnership activities, we have held that the profit motive analysis should be made at the partnership level. *Brannen v. Commissioner*, 78 T.C. 471, 505 (1982), affd. 722 F.2d 695 (11th Cir. 1984); *Siegel v. Commissioner*, 78 T.C. 659, 698 (1982). However, we have left unresolved the question of whether profit objective should be determined at the partner level, rather than the partnership level, where a section 761(a) election is made to be excluded from the

application of the provisions of subchapter K. *Ramsay v. Commissioner, supra* at 811; *Rosenfeld v. Commissioner*, 82 T.C. 105, 113 n. 13 (1984); *Madison Gas & Electric Co. v. Commissioner*, 72 T.C. 521, 559 n. 9 (1979), affd. 633 F.2d 512 (7th Cir. 1980).

In the instant case, petitioner contends that the making of a section 761(a) election does not affect the level at which profit motive is tested. That is, petitioner believes that the profit motive analysis continues to be performed at the partnership level notwithstanding a section 761(a) election. On the other hand, without conceding the validity of the section 761(a) election, respondent contends that the practical effect of a section 761(a) election is to divide the business activity of a partnership into a joint activity and an individual activity, and that, therefore, the profit motive analysis must be applied at the partnership level with respect to the joint activity and at the partner level with respect to the individual activity.

Resolution of the issue of what effect a section 761(a) election properly should have on the profit motive analysis would not affect the ultimate disposition of this case, since we conclude that petitioner has failed to carry his burden of establishing the requisite profit objective at either level. Perhaps significantly, petitioner did not testify in the trial of this case. Accordingly, at most, we can only infer his individual investor objective by examining the activities of the Wise County Mining Program in general. An examination of these activities leads us to conclude that the program's coal mining venture was not an activity engaged in with the primary and predominant objective of realizing an economic profit. Accordingly, we do not decide herein whether a valid section 761(a) election was made in this case and, if so, what effect such an election would have on our profit motive analysis.[15]

It cannot be gainsaid that the Wise County Mining Program was promoted as a tax shelter. The first written communication received by potential investors, dated November 28, 1978, summarizes the projected tax benefits as creating a taxable loss for 1978 of $74,340 for each $25,000 investment. Thus, assuming the investor was in a 50-percent tax bracket, he was offered the prospect of his tax savings exceeding his cash

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[15] Similarly, we express no opinion with respect to whether the Wise County Mining Program was in fact a "partnership" as defined in section 761.

outlay, thereby returning an immediate profit to him through the courtesy of the U.S. Treasury. This profit bore no relationship to the success, or lack thereof, of the coal mining operation. The offering memorandum subsequently received by investors reinforced the theme of tax benefits. An examination of the memorandum reveals unmistakably that the one topic most often discussed was the attractive tax benefits generated by the investment. In addition, Winer continued to tout the glories of additional tax-sheltered investments throughout his correspondence with investors in the program.

We do not accept petitioner's attempts to portray Winer as being knowledgeable in the business of coal mining. What the record reveals is that Winer had a great deal of experience in structuring tax shelters, many of which involved coal mining ventures. There is little evidence that he actually had any knowledge of the underlying coal mining business as such. In this connection, even the offering memorandum cautions investors that the operating manager had a limited background in the operation of a coal mining business. The record does reveal that Winer had experience in dealing with IRS challenges to losses reported by various ventures he promoted. In fact, some of those ventures have already been considered by this Court.[16] In our view, Winer's prior experience in dealing with the IRS and his knowledge of some of the factors looked to by this Court in determining the existence of a bona fide economic profit motive explain the rationale behind Winer's attempts to impress the overall transaction with the trappings of a bona fide venture. Notwithstanding his efforts in this respect, in our opinion the fact remains that tax considerations were Winer's paramount concern and that those considerations, rather than economic considerations, set the course of whatever actions were pursued by the program.

The fact that tax considerations, rather than economic considerations, laid the foundation for the program's actions may be illustrated by the making of the section 761(a) election. It is crystal clear from the record that the election was made in order to avoid the at-risk provision incorporated in section

[16] See *Seaman v. Commissioner*, 84 T.C. 564 (1985); *Maddrix v. Commissioner*, 83 T.C. 613 (1984), on appeal (11th Cir., Mar. 12, 1985); *Estate of Blay v. Commissioner*, T.C. Memo. 1984-565.

704(d) at the time the transaction was structured.[17] Winer was aware from Fieldstone's research that a section 761(a) election might not be respected under the IRS's ruling position unless (1) each investor reserved the right to take in kind and dispose of his respective share of any coal extracted, and (2) any delegation of authority to sell an investor's share of coal would be effective for no more than 1 year. Accordingly, under the terms of the joint operating agreement each investor reserved the right to his pro rata share of the coal mined and removed from the property and the right personally to sell or direct the sale thereof for his respective benefit. Under the sales agreement, each investor authorized Shelton Coal, as sales agent, to arrange for the sale of his respective pro rata share of the coal mined from the property. However, Shelton Coal was restricted from entering into contracts or commitments for the sale of coal that extended for a period in excess of 1 year. Shelton Coal's inability to enter into long-term contracts subjected the investors to a greater risk of market fluctuation and prevented them from taking advantage of favorable long-term contracts. This risk was specifically noted in the offering memorandum. Thus, while the section 761(a) election, if respected, could work to an investor's advantage from a tax perspective, it would do so at the possible expense of economic profitability. By requiring that investors agree to a section 761(a) election, Winer, as was his wont, allowed the tax considerations to predominate.

We find in the record numerous other examples of Winer's tendency to concern himself primarily with the tax aspects rather than the economic aspects of the transaction. For example, on learning of the mine closure order relating to the Amburgey Hollow property and Shelton Coal's request for an additional $1.60 per ton for services to be rendered on the Pardee property, Winer requested Fieldstone's advice with respect to whether the closing of the mine would affect the program's tax position. Further, the decision to hire Triangle Mining to resume operations on the Amburgey Hollow property was prompted, in large measure, by the need to place the program "in a better [position] to withstand an attack by the IRS on the tax treatment offered it." Correspondence pertain-

[17] See note 14.

ing to the decision to hire Triangle Mining is so ambiguous with respect to whether there would be any profit potential for the program as to leave us with the undeniable impression that profit potential was, at most, a subsidiary consideration. Winer's concern over preserving tax benefits at the expense of economic profitability goes to the heart of the profit motive issue.

Another indication of the absence of a primary profit motive is the fact that Roberts conducted only a superficial examination of the Amburgey Hollow property. Roberts' exploration of the property was completed in the course of 1 day, during which time he examined maps and other data provided to him by the Humphreyses, who, of course, controlled both the sublessor and the contract miner, and made an on-site inspection of the property. Roberts measured the coal seam at the site where mining was to commence on the smaller southern portion of the total tract. Roberts' observation of the larger, and more significant, portion of the tract was limited to viewing the property from a helicopter. By Roberts' own admission, he could not distinguish from the helicopter the thickness of the parting in the seam. Roberts' prepared his report on the property largely on the basis of the data he obtained from the Humphreyes and his brief on-site inspection of the property. It is abundantly apparent to us that Roberts' examination of the property was far too cursory to serve as a reasonable basis upon which to formulate a meaningful estimate of reserves.

The extent of the shale parting that ran throughout the Clintwood seam had a direct bearing on the coal reserve estimates and the minability of the property. The thickness of the parting was particularly relevant in this case, since it was contemplated that a 14 C.M. Joy continuous miner would be used to remove the coal. A continuous miner is a piece of mining equipment that cuts through the entire seam of coal, including the parting; therefore, the discrepancy between the raw tonnage and the clean tonnage mined with a continuous miner can be very significant. The evidence before us clearly indicates that Roberts paid scant attention to the importance of the parting in the Clintwood seam. There were no coal sample records, which would have revealed the extent of the partings, available at the time Roberts examined the property,

and Roberts himself did not perform any core drillings. In fact, as noted, Roberts did not even observe with the naked eye the extent of the parting on the larger northern portion of the tract. An examination of the maps of the Amburgey Hollow property reveals that it was the coal seam characteristics on the northern portion of the tract that were of crucial importance. Thus, Roberts' close observation of the coal seam outcropping *only* on the southern portion of the tract, where development would begin, seems misguided at best. Furthermore, although the Humphreyses apparently made all maps of the Amburgey Hollow property available to him, Roberts failed to examine a map that was revised only 11 months before his on-site inspection of the property and that revealed extensive shale parting throughout the coal seam.

Aside from the extent of the parting, Roberts failed to consider a number of other factors that would have been relevant, indeed crucial, in rendering a fair and accurate report on the property. For example, he failed to consider the effect on reserves of Paramont's ongoing strip mining operation. He concluded that Humphreys Enterprises had sufficient backup reserves to satisfy its guarantee to provide the program with 1,500,000 tons of recoverable reserves. However, in so concluding, he failed to inquire with respect to the legal status of existing property rights to these reserves. Finally, in our view, he failed to compensate adequately for the extent to which the property previously had been mined. Roberts testified that his use of a 75-percent recovery factor in estimating reserves compensated for old mine works by leaving a barrier pillar around the old works that were revealed on the maps he examined.[18] However, by Roberts' own admission at trial, it is common to encounter unmapped mine workings. According to respondent's expert, Thomas W. Howard, one can safely assume that mapped old mine works are more extensive than shown on the map because miners typically do not hire an engineer to go into the mine and map mine works that they have finished mining. In Howard's opinion, the unmapped old works hit by Shelton Coal were extensions of the mapped old mine works, and Shelton Coal reasonably should have ex-

[18] We note that Roberts subsequently testified that, in calculating the reserves, he assumed a 25-percent reject rate to compensate for the parting in the seam.

pected to hit those extensions. Even Roberts admitted that the old works hit were extensions of the mapped old works.

At trial, Roberts defended his estimate of reserves by pointing to the reserve study subsequently prepared by Paramont, which indicated total tonnage in place of 2,254,583 tons. We fail to see how this study provides a meaningful yardstick by which to compare Roberts' study. Paramont's calculation of coal reserves in place was computed over more acreage than Roberts' calculation. Furthermore, Paramont's study indicated an average seam characteristic of 39 inches coal, 24 inches shale, and 36 inches coal. Roberts, on the other hand, measured the coal at 90 inches in height, with an average shale parting of only 5 inches. Furthermore, subsequent core drilling studies performed on behalf of Paramont revealed a parting ranging from approximately 20 inches to some 5½ feet in thickness.

Roberts' report, in addition to being based on an insufficient exploration of the property, is deficient in other respects. His financial evaluation appears aimed primarily at justifying the "development" costs charged by Shelton Coal. In other words, the report does not appear to have been prepared for the purpose of determining whether, in fact, development of the property was commercially feasible. In the first place, his use of an anticipated $25-selling price per ton of coal was not based on any sort of independent study of marketability. By Roberts' own admission, he used the $25 figure because the Humphreyses told him that that was the price that they would receive from the Paramont tipple. This anticipated selling price was apparently based on the November 14, 1978, agreement between Humphreys Enterprises and Paramont, which provided that the latter corporation possessed the right-of-first-refusal to purchase coal mined from the Amburgey Hollow property on a clean-ton basis for $23.50 per ton, subject to price adjustments. Obviously, this agreement, alone, does not provide an adequate basis upon which to project a $25 selling price. The agreement neither guarantees a $23.50 selling price, let alone a $25 selling price, nor does it guarantee coal sales. In the second place, although Roberts' operating cost estimate took into account an estimate for investor profit, this latter estimate for profit did not take into account certain expenses that should have been taken into account in project-

ing the profitability of the venture to the investors. Such omitted expenses included, for example, the initial management fee of $80,750, the per-ton administrative fee of $0.50, and the per-ton sales commission fee of $0.25.

In short, after reviewing all of the evidence, we are left with a definite impression that, while Roberts is a qualified mining engineer, in carrying out his assignment with respect to the Amburgey Hollow property, he did no more than what Winer required of him, which was to prepare a report that would appear bona fide in the event that the program might ultimately run into trouble with the IRS.

Aside from Roberts' deficient evaluation, the only other evaluation of the potential profitability of the program was the equally deficient financial projections contained in the offering memorandum. Those projections were based on several unwarranted assumptions. For example, the projections assumed sales of 120,000 tons of coal per year until the exhaustion of all recoverable reserves. However, in estimating operating costs, Roberts projected only 90,000 tons per year of salable coal. Furthermore, the projections assumed a sales price of "$25.00 per ton f.o.b. at the tipple siding or wash plant." Again, for the reasons stated above, we believe that the assumption of a $25 sales price per ton was not warranted considering that there was virtually no investigation of the matter. Further, the $25 sales price figure used in the financial projection appears to have been based on the sale of raw tonnage rather than clean tonnage. However, Paramont had the right of first refusal to purchase coal mined from the Amburgey Hollow property for $23.50 per ton on a *clean-ton* basis.

We are not persuaded by petitioner's attempt to portray the program as being run in a businesslike fashion. While the evidence reveals that Winer did make certain commitments to the operational aspects of the program, when the dust settles, we cannot help but agree with Jackson's opinion, articulated in his testimony, that Winer took his initial "$80,000-odd and * * * tipped his hat to the problems, just cursorily attempted solutions, and then went on to other things."

Petitioner contends that Winer continually and diligently attempted to enforce the program's "turnkey" rights against the Humphreyses and Shelton Coal after Shelton Coal invoked

the force majeure provision. In our view, if Winer believed that a "turnkey" contract had been breached, he was duty-bound to take some legitimate action to enforce the program's rights.[19] Instead, he did little more than make idle, innocuous complaints to the Humphreyses about the lack of operations. The various agreements executed by the parties provided the investors with a number of remedies that were never pursued by Winer, as president of the operating manager. We agree with respondent that it is very curious that Shelton Coal insisted that it was in a force majeure situation, but nonetheless began to look for subcontractors to mine the Amburgey Hollow property at about the same time that the IRS began to challenge the deductions taken by some of the investors. This leads us to believe that either the parties did not believe that a force majeure situation truly existed or that they were so concerned over preserving tax benefits that they seemingly found it convenient to "forget" that a force majeure situation existed. In addition, the record does not reveal any attempts to lift the mine closure order by submitting to the mining inspectors an alternative mining plan.

Winer also failed to communicate with investors in a responsible fashion. Although the initial distributions of coal sales proceeds to investors were accompanied by written correspondence from Winer, the communications dwindled after the distributions ceased. In addition, Winer failed to inform the investors of the operational difficulties encountered by Shelton Coal until November 1979. Yet, Winer had learned as early as April 1979 that Shelton Coal had begun hitting extensive old mine works.

The documents executed by all parties concerned clearly called for joint action by the investors. However, in practice, Winer ran the show and does not appear to have elicited any input from investors with respect to the decision-making processes. This fact is most vividly illustrated by Winer's refusal to turn over the names of the investors to Jackson, who wanted to institute action to replace Investors Coal Co. as operating manager.

Petitioner contends that, in making our determination of whether the requisite profit motive existed in this case, it is

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[19] The foregoing is not intended to imply an acceptance of petitioner's characterization of the program's rights as "turnkey" in nature.

inappropriate for us to take into account the fact that anticipated economic projections were not met by the program. Of course, we agree with petitioner that the operational failure of a particular transaction in and of itself does not destroy an otherwise valid profit motive; however, it is a relevant factor to be taken into account in determining whether there was an adequate preliminary investigation performed with respect to the property and whether the parties to the coal mining venture in question possessed a bona fide intent to mine and sell coal for economic profit at the time they entered into the transaction. In this connection, we cannot refrain from adding that many, if not most, of the plethora of coal shelter cases that have come before this Court recently, some of which were promoted by Winer, himself, have been financial debacles. It is not surprising, therefore, that this Court has grown skeptical of the myriad of excuses advanced by taxpayers for the financial failure of one coal tax shelter after another. The same is true in the instant case.

Petitioner argues that the financial calamities encountered by the program were attributable to unforeseen circumstances, including depressed market conditions. It is difficult for us to accept the proposition that unforeseen circumstances caused the economic adversity with which the coal mining venture met, in light of our conclusions that the preliminary investigations of the economic viability of the venture were scanty and superficial, that the activities of the program were not conducted in a businesslike fashion, and that there was virtually no meaningful investigation into the marketability of the coal. One cannot simply shut one's eyes to the circumstances that may impact upon the viability of a transaction and then be heard to complain that unforeseen circumstances caused the economic downfall of that same transaction. We also note that petitioner presented no credible and verifiable evidence with respect to the prevailing market prices for coal during the years in question. With the foregoing in mind, we direct our attention to a comparison of actual to projected results from operations.

The program estimated production of 120,000 tons of salable coal per year, or 1,500,000 tons of salable coal over the course of the lease agreement. However, from the inception of the program through June 10, 1982, when mining operations

terminated, total clean tonnage mined equaled approximately 36,822.75 tons. Therefore, less than 3 percent of total estimated salable reserves was mined during this period. Likewise, less than 3 percent of the 1,500,000 minimum salable coal reserves warranted by Humphreys Enterprises was mined during this time. Average tonnage of clean coal mined over the 4-year period from 1979 through 1982 was approximately 9,206 tons per year. Therefore, less than 8 percent of the annual estimated coal production of 120,000 tons per year was realized over the 4-year period. Likewise, less than 8 percent of the minimum tonnage warranty of 120,000 tons per year was realized from mining operations from the inception of the program until mining was terminated. With respect to the cash distributions to petitioner, the financial projections included in the offering memorandum projected $18,756 of cash distributions per unit investment for the years 1979 through 1982 and total cash distributions for the life of the lease of $74,460. However, during the years 1979 through 1982, when mining was terminated, petitioner, who purchased one unit of investment, received cash distributions totaling only approximately $1,286. Therefore, petitioner realized less than 7 percent of his projected cash distributions for the 4-year period from 1979 through 1982 and less than 2 percent of his projected cash distributions for the life of the lease.

Petitioner makes much of the fact that the "final score on this project has not yet been tallied." Maybe not, but we seriously doubt that any investor has written in for playoff tickets. He alleges that the program is still viable and that negotiations with Paramont for the resumption of mining the Clintwood seam are ongoing. Based on what the record reveals with respect to negotiations up to the time of trial, we have serious doubts that any resumption of mining by Paramont on the investors' behalf will prove economically profitable to them. Paramont's proposal to mine the Clintwood seam specifically stated that the corporation would be willing to pay only a 1-percent royalty to the Wise County Mining Program and further stated that Paramont would only mine the top portion of the coal seam above what Paramont characterized as excessive parting.

Our conclusion that the primary objective of the Wise County Mining Program was to secure tax benefits rather

than to earn an economic profit is buttressed by the large nonrecourse notes executed by the investors. We have indicated on numerous prior occasions that the existence of large nonrecourse notes in circumstances where it is unlikely that the notes will be paid is itself an indication that the primary objective of an activity is to generate tax deductions. See, e.g., *Seaman v. Commissioner*, *supra* at 596; *Ramsay v. Commissioner*, *supra* at 820; *Estate of Baron v. Commissioner*, 83 T.C. 542, 556 (1984), on appeal (2d Cir., Mar. 26, 1985); *Surloff v. Commissioner*, *supra* at 237–238; *Flowers v. Commissioner*, *supra* at 937.

The totality of the facts reveals that the notes in question were contingent in nature and actually payable only in the event that coal sales proceeds were realized. Although there apparently were no written agreements to this effect, it is clear that the parties so understood this to be the arrangement for paying off the notes. Evidently it was agreed that the notes would be amortized at the rate of $2.34 per ton of coal sold. At least, in practice, this is precisely what occurred. However, it was further agreed that, in the event Shelton Coal mined less than 120,000 tons of coal per year, the corporation would pay the investors "liquidated damages" in an amount sufficient for the investors to amortize their notes to the corporation. Winer and the Humphreyses reached a verbal agreement that Shelton Coal would not pay the investors the "liquidated damages" in cash, but rather would simply offset the balance of the notes. Thus, if coal sales proceeds were realized, a portion of those proceeds would be applied to amortize the notes and the remaining amount due under the notes would be extinguished by the so-called "liquidated damages." If no coal sales proceeds were realized, the notes would be satisfied entirely by way of the offsets generated through the "liquidated damages" arrangement. The net effect of the overall arrangement was that the investors would never be obligated to make an additional out-of-pocket cash payment in order to amortize their notes. Thus, petitioner herein purchased his initial $73,243 tax benefit for the grand total of $25,000.

Petitioner contends that his nonrecourse note was not contingent because the note "has been and will immutably be paid each and every year in the absence of mining." According to petitioner, due to the presence of the liquidated damages

arrangement, "There is no contingency whatsoever which could preclude the amortization of the deferred mining development obligation." In addition, petitioner points out that he is burdened with non-cash taxable income each year as the note is amortized by the offset arrangement. In our view, petitioner's contention is wholly without merit. On at least three separate occasions, we recently have rejected the contention that offset arrangements such as the one involved in the instant case cure the otherwise contingent nature of a nonrecourse note. *Seaman v. Commissioner*, *supra* at 599; *Maddrix v. Commissioner*, 83 T.C. 613, 623–625 (1984); *Estate of Blay v. Commissioner*, T.C. Memo. 1984–565. In the instant case, as in the prior cases, the parties never intended to make an actual cash payment of principal or interest if coal was not mined. Thus, the note was clearly contingent. Petitioner's contention that the note would be amortized immutably each year, even in the absence of mining, is particularly surprising in this case considering the parties took the position that a force majeure situation excused Shelton Coal from performing its minimum mining commitment and concomitantly excused "payment" of liquidated damages. In addition, petitioner's contention that he has been burdened with non-cash taxable income each year as the note is amortized by the offset arrangement is not supported by the record. Petitioner's Federal income tax returns for the years 1978 through 1982 were stipulated into evidence. An examination of those returns reveals that the only year in which petitioner took the so-called liquidated damages into account was 1982, a year that, of course, postdates the inception of the IRS audit.

The provision for giving the nonrecourse notes as payments of "mine development" expenses had absolutely no apparent business purpose. Petitioner's contention that the notes were given at the Humphreyses' request for assurance that the deferred mining expenses would be paid, simply will not withstand scrutiny. The face value of the notes had no bearing whatsoever on the amount that Shelton Coal would ultimately receive for mine development since such amount was wholly dependent upon the results of mining. Similarly, the purpose of the note could not have been to assure Shelton Coal of sufficient cash flow to finance mine development, since the

cash flow likewise was wholly dependent upon the results of mining.

There also appears to have been no business purpose for the offset arrangement. Winer testified that this arrangement was formulated to protect the investors' leasehold interests by preventing a default on the notes. However, the investors' leasehold interests would have been protected to the same extent, and the parties would have found themselves in essentially the same economic position, had they merely agreed to an initial $695,000 cash payment for mine development and a $2.40-per-ton development fee.

Failing to find any valid business purpose for the giving of the nonrecourse notes, we must and do conclude that the requirement that the notes be integrated into the transaction was intended to provide the investors with tax deductions, which in turn made it possible for the promoter to sell the working interests in the program. Cf. *Surloff v. Commissioner*, *supra* at 237.

Having concluded that petitioner has failed to carry his burden of proving that the coal mining activity was engaged in with the primary and predominant objective of making an economic profit, we need not address respondent's alternative arguments for disallowance of the claimed "mining development" expense.[20]

Operating Management Fee

On his Schedule C attached to his 1978 Federal income tax return, petitioner claimed a deduction of $2,211 for "operating management fees," which represented his allocable share of the $80,750 initial management fee received by Investors Coal as operating manager.

Respondent contends that petitioner is not entitled to a deduction for operating management fees because the program's mining activity was not an activity engaged in for profit and thus was not a trade or business within the meaning of section 162. Respondent also contends that, in any event, the operating management fees were not ordinary and necessary business expenses within the meaning of section 162(a),

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[20] Since the Wise County Mining Program generated no income in 1978, sec. 183(b)(2) is not applicable.

but, instead, were organizational expenses that must be capitalized. Petitioner, on the other hand, obviously contends that the operating management fees were ordinary and necessary expenses. His brief, however, fails otherwise to elaborate on his theory of deductibility.

In order for the operating management fees to be deductible, the requirements of section 162(a) must be satisfied. *Cagle v. Commissioner*, 63 T.C. 86, 91 (1974), affd. 539 F.2d 409 (5th Cir. 1976). It follows from our holding that the program's mining activity was not engaged in with the primary objective of making a profit, that the mining activity was not a trade or business within the meaning of section 162. Therefore, the management fees do not satisfy the requirements of section 162(a). Cf. *Surloff v. Commissioner*, *supra* at 240.

Moreover, we agree with respondent that the record indicates that the operating management fees were organizational expenses, which would have to be capitalized in any event. *Surloff v. Commissioner*, *supra* at 240; *Estate of Boyd v. Commissioner*, 76 T.C. 646, 659 (1981); *Kimmelman v. Commissioner*, 72 T.C. 294, 305–306 (1979); *Cagle v. Commissioner*, *supra*.

Professional Fees

On his Schedule C attached to his 1978 Federal income tax return, petitioner claimed a deduction of $534 for "professional fees," which apparently represented his allocable share of $30,500 of "professional fees" paid by the program.[21]

Respondent contends that petitioner has failed to proffer sufficient evidence with respect to the deductibility of the professional fees and that, at any rate, the fees should have been capitalized.

We agree with respondent that petitioner has failed to carry his burden of proof on the issue. There was some brief testimony at trial with respect to the payment of "legal and accounting fees." In addition, the offering memorandum noted that $30,500 of the proceeds from the offering would be used

[21] Petitioner's Schedule C did not actually specify a $534 expense for professional fees. However, the reporting information sent to petitioner for purposes of filling out his Schedule C took this expense into account, and based on an examination of petitioner's Schedule C, it is clear to us that the total expenses claimed by petitioner included the expense for professional fees.

for "organizational expenses, legal fees, accounting fees and printing costs." Petitioner's brief goes no further than to refer to the alleged fact that "legal and accounting fees" were paid.

There is nothing in the record that would enable us to determine precisely what expenses made up the $534 "professional fees" claimed by petitioner. Since petitioner bears the burden of proof on this issue, it was incumbent upon him to enlighten the Court on this matter. Under the circumstances, we must hold that petitioner failed to carry his burden of proof on the issue, and we must sustain respondent's disallowance of the deduction.[22]

Decision will be entered under Rule 155.

RICHARD E. MURPHY, JR., AND NANCY D. MURPHY, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 42417–84. Filed June 6, 1985.

Ps calculated their taxes solely according to sec. 1348, I.R.C. 1954, as amended. *Held*, because Ps' income falls within the terms of secs. 55 and 1348, I.R.C. 1954 as amended, their income is subject to both sets of taxes.

Don S. Harnack, for the petitioners.

Thomas J. Kane and *Phyllis W. Greenblum*, for the respondent.

OPINION

DAWSON, *Judge*: Respondent's motion for summary judgment was assigned to Special Trial Judge Francis J. Cantrel

[22] "Petitioner does not contend that part of the "professional fees" are deductible under sec. 212(3) as ordinary and necessary expenses paid or incurred during the taxable year "in connection with the determination, collection, or refund of any tax." There is some indication that part of the "professional fees" may have been paid to Price Waterhouse & Co. in connection with various services rendered to the Wise County Mining Program. However, the record is too sparse to enable us to determine whether some portion of the "professional fees" may have been properly deductible under sec. 212(3). Cf. *Surloff v. Commissioner*, 81 T.C. 210, 241 (1983).

for hearing, consideration, and ruling thereon.[1] After a review of the record, we agree with and adopt his opinion which is set forth below.

OPINION OF THE SPECIAL TRIAL JUDGE

CANTREL, *Special Trial Judge*: This case is before the Court on respondent's Motion for Summary Judgment, filed on March 22, 1985, pursuant to Rule 121, Tax Court Rules of Practice and Procedure.[2]

The case was set for hearing at the motions session of the Court on April 24, 1985, at which time respondent's counsel appeared and presented argument. Counsel for petitioners was not present; however, his office advised the Court that a response to respondent's motion had been mailed to the Court. Rather than a response, the Court received and filed on April 24, 1985, petitioners' motion for summary judgment and an accompanying Memorandum. We have fully considered those documents in our disposition of respondent's motion.

Respondent issued a notice of deficiency to petitioners on October 18, 1984, in which he determined a deficiency in Federal income taxes for the taxable calendar year 1981 in the amount of $38,753.04. This amount was determined by applying the alternative minimum tax provisions of sections 55 to 58[3] to petitioners' reported income, deductions, and credits in their joint return.

Petitioners lived in Winnetka, Illinois, at the time they filed their timely petition in which they claimed that the alternative minimum tax provisions were not applicable to them.

Petitioners computed their taxes for 1981 based upon the maximum tax on personal service income. The undisputed section 1348 taxes were computed as follows:

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[1] This case was assigned pursuant to Delegation Order No. 8 of this Court, 81 T.C. XXV (1983).
[2] All Rule references are to the Tax Court Rules of Practice and Procedure.
[3] All section references are to the Internal Revenue Code of 1954 as amended.

Personal service net income	$364,341.48
Corrected taxable income	184,847.87
Tax preference items, *other than capital gain deduction* (sec. 1348(b)(2)(B))	0
Personal service taxable income (sec. 1348(b)(2)(A))	184,847.87
Less: Amount from sec. 1348(a)(1)	(60,000.00)
	124,847.87
Amount from sec. 1348(a)(2)	62,423.94
Excess of sec. 1 tax (without regard to sec. 1348 over tax computed solely on personal service income	19,678.00
Less: Rate reduction credit (1.25%)	(245.98)
Maximum tax on personal service income	*81,855.96

Respondent calculated petitioners' taxes based on the alternative minimum tax provisions, allowing petitioners' use of the maximum tax on personal service income, as follows:

Corrected taxable income	$184,847.87
Less: Zero bracket amount (sec. 55(b)(1)(A))	(3,400.00)
	181,447.87
Increased by: Sum of tax preference items for adjusted itemized deductions	0
Capital gain deduction (sec. 55(b)(1)(C))	344,604.00
Alternative minimum taxable income (sec. 55(b)(1))	526,051.87
Amount taxable at 10% – $40,000	4,000.00
Amount taxable at 20% – $40,000	8,000.00
Amount taxable at 25% – 426,051.87 (sec. 55(a)(1))	106,512.97
Tentative alternative minimum tax	118,512.97
Less: Regular tax – (sec. 55(b)(2))	(79,760.45)
Alternative minimum tax	38,753.00 (rounded to nearest dollar)

The issue for decision in this case is whether the alternative minimum tax provisions of sections 55 to 58 apply to individuals who have calculated their taxes according to section 1348, which sets forth a 50-percent maximum rate on personal service income.

Respondent asserts that the alternative minimum tax is applicable to petitioners because petitioners' taxable income

*These computations reflect petitioners' taxes as shown on their 1981 return and their amended return dated Apr. 14, 1982. The corrected items shown on the amended return bear no relevance to the issues in this case.

falls within the parameters set forth in section 55, and no provisions extricate petitioners from application of the alternative minimum tax.

Petitioners, on the other hand, argue that because they fit within the provisions of section 1348 (50-percent maximum tax on personal service income) their income is not further subject to the alternative minimum tax. They cite the legislative history of the original provision and the 1978 amendment to section 1348 to support their theory.

For the reasons we discuss herein, we hold that calculation of an individual's taxes pursuant to section 1348 does *not* preclude application of the alternative minimum tax provisions where the individual's income also comes within the plain language of section 55.

The relevant portions of sections 55, 57, and 1348, which were in effect in 1981, are set out below:

SEC. 55. ALTERNATIVE MINIMUM TAX FOR TAXPAYERS OTHER THAN CORPORATIONS.

(a) ALTERNATIVE MINIMUM TAX IMPOSED.—In the case of a taxpayer other than a corporation, if—

(1) an amount equal to the sum of—

(A) 10 percent of so much of the alternative minimum taxable income as exceeds $20,000 but does not exceed $60,000, plus

(B) 20 percent of so much of the alternative minimum taxable income as exceeds $60,000 but does not exceed $100,000, plus

(C) 25 percent of so much of the alternative minimum taxable income as exceeds $100,000, exceeds

(2) the regular tax for the taxable year,

then there is imposed (*in addition to all other taxes imposed by this title*) a tax equal to the amount of such excess.

(b) DEFINITIONS.—For purposes of this section—

(1) ALTERNATIVE MINIMUM TAXABLE INCOME.—The term "alternative minimum taxable income" means gross income—

(A) reduced by the sum of the deductions allowed for the taxable year,

(B) reduced by the sum of any amounts included in income under section 86 or 667, and

(C) increased by an amount equal to the sum of the tax preference items for—

(i) adjusted itemized deductions (within the meaning of section 57(a)(1)), and

(ii) capital gains (within the meaning of section 57(a)(9)).

For purposes of subparagraph (A), a deduction shall not be taken into account to the extent such deduction may be carried to another taxable year.

(2) REGULAR TAX.—The term "regular tax" means the *taxes imposed by this chapter for the taxable year* (computed without regard to this section and without regard to the taxes imposed by sections 72(m)(5)(B), 402(e), 408(f), 409(c), and 667(b)) reduced by the sum of the credits allowable under subpart A of part IV of this subchapter (other than under sections 31, 39 and 43). For purposes of this paragraph, the amount of the credits allowable under such subpart shall be determined without regard to this section.

(3) TREATMENT OF ZERO BRACKET AMOUNT.—In the case of an individual who does not itemize his itemized deductions, the zero bracket amount shall be treated as a deduction allowed.

[Emphasis added.]

* * * * * * *

SEC. 57. ITEMS OF TAX PREFERENCE.

(a) IN GENERAL.—For purposes of this part, the items of tax preference are—

* * * * * * *

(9) CAPITAL GAINS.—

(A) INDIVIDUALS.—In the case of a taxpayer other than a corporation, an amount equal to the net capital gain deduction for the taxable year determined under section 1202.

* * * * * * *

SEC. 1348. 50-PERCENT MAXIMUM RATE ON PERSONAL SERVICE INCOME.

(a) GENERAL RULE.—If for any taxable year an individual has personal service taxable income which exceeds the amount of taxable income specified in paragraph (1), the tax imposed by section 1 for such year shall, unless the taxpayer chooses the benefits of part I (relating to income averaging), be the sum of—

(1) the tax imposed by section 1 on the highest amount of taxable income on which the rate of tax does not exceed 50 percent,

(2) 50 percent of the amount by which his personal service taxable income exceeds the amount of taxable income specified in paragraph (1) of this subsection, and

(3) the excess of the tax computed under section 1 without regard to this section over the tax so computed with reference solely to his personal service taxable income.

(b) DEFINITIONS.—For purposes of this section—

(1) PERSONAL SERVICE INCOME.—

(A) IN GENERAL.—The term "personal service income" means any income which is earned income within the meaning of section 401(c)(2)(C) or section 911(b) or which is an amount received as a pension or annuity which arises from employer-employee relationship or from tax-deductible contributions to a retirement plan. * * *

(2) PERSONAL SERVICE TAXABLE INCOME.—The personal service taxable income of an individual is the excess of—

(A) the amount which bears the same ratio (but not in excess of 100 percent) to his taxable income as his personal service net income bears to his adjusted gross income, over

(B) the sum of the items of tax preference described in subsection (a) (other than paragraph (9)) of section 57 for the taxable year.

Contrary to petitioners' stance, the interworkings of these provisions carry out congressional intent.[5] Section 55 on its face clearly applies "in addition to all other taxes imposed by" the Internal Revenue Code. See *Huntsberry v. Commissioner*, 83 T.C. 742 (1984). Cf. also *Lubus v. United States*, 573 F.2d 1292 (2d Cir. 1978) (dealing with the scope of former section 56 as applied to the individual minimum tax). The alternative minimum tax is the formulated excess set out in section 55 over the "regular tax." The section 55 tax, although denominated an alternative tax, is actually imposed only if and to the extent that the alternative tax computation *exceeds* the taxpayer's regular liability. *Warfield v. Commissioner*, 84 T.C. 179 (1985); S. Rept. 95–1263, 1978–3 C.B. (Vol. 1) 499. Section 55(b)(2) also makes it clear that the regular tax includes all other income taxes. Although that section enumerates certain exceptions, it does *not* list as one of the exceptions the tax imposed by section 1348. Section 1348 is an income tax within the same chapter (chapter 1) of the Internal Revenue Code as section 55.

The alternative minimum tax is imposed on "alternative minimum taxable income," which is gross income reduced by certain deductible items and increased by certain tax preference items. Sections 55(b)(1)(C)(ii) and 57(a)(9) provide that the net capital gain deduction is an item of tax preference which increases a taxpayer's gross income to reach the alternative

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[5] Petitioners and respondent each cite legislative history of both secs. 55 and 1348 to support their respective positions. In *Huntsberry v. Commissioner*, 83 T.C. 742, 747–748 (1984), also a case dealing with sec. 55, we stated that where a statute is clear on its face we will ordinarily not inquire into legislative purposes to override the plain meaning of the statute. Plainly, sec. 55 means that the alternative minimum tax should be applied as we direct herein. Furthermore, we held that no good reason existed not to apply sec. 55 as written. *Huntsberry v. Commissioner, supra* at 745–746.

Moreover, the legislative history of sec. 55 makes the Congress' intent clear that it wished to impose the alternative minimum tax in addition to all other income taxes. S. Rept. 95–1263, 1978–3 C.B. (Vol. 1) 501. Petitioners' reliance on portions of the legislative history of sec. 1348 simply does not support their position.

minimum taxable income.[6] This net capital gain deduction is excluded from the taxpayer's personal service taxable income for purposes of calculating the regular tax pursuant to section 1348.

In effect, for those taxpayers who have both high personal service income and high capital gain, these two taxing provisions place a cap on the tax of their personal service income, but allow the alternative minimum tax to come into play on the net capital gain deduction so that these taxpayers will pay at least the minimum amount of tax with respect to large capital gains. H. Rept. 95–1445, 1978–3 C.B. (Vol. 1) 296. See also *Warfield v. Commissioner, supra.* We therefore grant respondent's motion for summary judgment and deny petitioners' motion for summary judgment.

Decision will be entered for the respondent.

NEW MEXICO TIMBER COMPANY, A NEW MEXICO CORPORATION, T. P. GALLAGHER AND BARBARA GALLAGHER, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 24199–82. Filed June 17, 1985.

Held, "gross receipts," within the meaning of sec. 1372(e)(5), I.R.C. 1954, realized by a small business corporation trading in commodity futures contracts, equals the total amount received, unreduced by any fees and commissions, and is not limited to gains from such transactions.

John S. Campbell, for the petitioners.
James E. Polk, for the respondent.

KÖRNER, *Judge*: Respondent determined deficiencies in Federal income tax against petitioners as follows:

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[6] Sec. 1202 provides that 60 percent of the amount of a taxpayer's net capital gain shall be deducted from gross income.

Petitioner	*TYE*	*Deficiency*
New Mexico Timber Co.	Apr. 30, 1979	$62,055
	Apr. 30, 1980	46,420
	Apr. 30, 1981	56,323
Total		164,798
T.P. Gallagher	Dec. 31, 1979	18,662
and Barbara Gallagher	Dec. 31, 1980	75,017
Total		93,679

The only issue for us to decide is whether the amount of "gross receipts," within the meaning of section 1372(e)(5),[1] realized by a small business corporation trading in commodity futures contracts, equals the total amount realized, or whether such receipts are taken into account only to the extent of the gains from such transactions, unreduced by any fees or commissions.

This case was submitted to the Court under the provisions of Rule 122, upon a set of stipulated facts and exhibits. The stipulation of facts, supplemental stipulation of facts, and joint exhibits attached thereto are incorporated herein by this reference and form the basis of our findings of fact.

FINDINGS OF FACT

New Mexico Timber Co. (hereinafter NMT) was, during the years in issue, a New Mexico corporation, with principal offices in Albuquerque, New Mexico.

T.P. Gallagher (hereinafter T.P.) and Barbara Gallagher were husband and wife and residents of Albuquerque, New Mexico, at the time the petition herein was filed. T.P. was the sole shareholder, president, and chief executive officer of NMT at all times material hereto.

In 1959, T.P. purchased 100,000 acres of standing timber in the Valle Grande in Sandoval County, New Mexico (hereinafter the Baca location) and 116,000 acres of standing timber in Sandoval County, New Mexico, in the San Diego Land Grant (hereinafter the San Diego location). T.P. also purchased a saw

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[1] All statutory references are to the Internal Revenue Code of 1954 as in effect in the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted. The provisions of the Subchapter S Revision Act of 1982, Pub. L. 97-354, 96 Stat. 1669, as amended by the Technical Corrections Act of 1982, Pub. L. 97-448, 96 Stat. 2365, and the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, are not retroactive and are inapplicable to the facts herein.

mill, logging equipment, a planing mill, dry kilns, and other equipment used in the production of lumber, the inventory and receivables of NEMTICO, INC., and a tract of real property located in Bernalillo, Sandoval County, New Mexico (hereinafter the Bernalillo land). The timber and the other assets were then transferred to NMT's predecessor,[2] of which T.P. was the sole shareholder, and later to NMT. The latter was engaged in various activities, including the sale of standing timber, lumber manufacturing, and the wholesale purchase and sale of manufactured timber. NMT acquired equipment and other operating assets, from time to time, in connection with its various businesses.

In 1963, NMT sold the San Diego location. The Baca location was sold, in a transaction qualifying for reporting under the installment method of section 453, in 1972; the last installment payment was received by NMT in June 1981.

NMT decided to cease its lumber business and to liquidate the equipment on May 1, 1976. As of May 1, 1976, and at all times until April 30, 1978, NMT was an electing small business corporation. No voluntary revocation of NMT's small business corporation election was filed by its shareholders during the years in issue.

In November 1978, NMT sold the Bernalillo land in a transaction qualifying for the installment method of reporting of section 453.

Between 1976 and 1979, T.P. discussed the possibility of liquidating and dissolving NMT with his accountants. T.P. was advised that a liquidation would have unfavorable income tax consequences resulting from the disposition of the installment obligations received by NMT in the sale of the Baca location and the Bernalillo land, pursuant to the provisions of section 453(d). T.P. was also advised that in order for NMT to avoid the automatic termination provisions of section 1372(e)(5) and retain its status as an electing small business corporation, its gross receipts from passive income sources, viz, royalties, dividends, interest, and gains from the sales or exchanges of stock or securities, had to be less than 20 percent of its gross receipts. Gross receipts from passive investment income sources did not equal or exceed 20 percent of total gross

[2] All references to NMT include its predecessor.

receipts of NMT during its taxable years 1976 through April 30, 1978.

In 1978, NMT was approached by Hanseatic Commodities Advisors (hereinafter Hanseatic), a commodity futures consulting firm, concerning trading in commodity futures. NMT decided to attempt to make profits by trading in commodity futures contracts.

A commodity futures contract is a firm commitment to deliver or to receive a specified quantity and grade of a commodity during a designated month in the future (the delivery month) at a specified price. All the terms and provisions of a futures contract are fixed by the bylaws and rules of the commodity exchange on which the contract is traded, except for the price and the delivery month, which are agreed upon at the time a trade is made on the floor of the exchange. A person entering into a commodity futures contract to sell a commodity, viz, to deliver the commodity, is obligated to deliver the commodity in the delivery month, unless he has disposed of the contract in the meantime; this is known as taking a "short position." A person buying a commodity futures contract to purchase a commodity, viz, to accept delivery of the commodity, is obligated to accept delivery of the commodity in the delivery month and pay for the commodity at the specified contract price, unless he has disposed of the contract in the meantime, although his liability for the payment of such money on any day before the delivery date is limited to the margin call on that particular day;[3] this is known as taking a "long position." If the price of the underlying commodity falls, the trader must either satisfy the margin call requirements or liquidate his position at a loss.

The holders of both long and short positions can close out their contracts, without making or taking delivery of the commodity, by entering into offsetting purchases or sales of futures contracts on the exchange.[4] Pursuant to the rules of the various exchanges, the offsetting purchase or sale cancels the obligation to accept or deliver the underlying commodity. Thus, the holder of a long commodity futures contract can cancel or offset his obligation to purchase and pay for the

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[3] See note 5 *infra*.

[4] Holders of commodity futures contracts can only close out their positions by delivery or offset; they cannot transfer them to third parties.

commodity by acquiring from another the promise to purchase and pay for the same commodity on the same exchange for the same delivery month, that is, by entering into an offsetting short contract, and vice versa.

NMT established a commodities futures trading account with Merrill Lynch Pierce Fenner & Smith, Inc. (hereinafter Merrill Lynch), a brokerage firm, pursuant to the terms of a commodity account agreement. Under the terms of the aforesaid agreement, NMT agreed that:

(a) Any and all transactions would be subject to the constitution, rules and regulations, customs and usages of the exchange or market where any transaction was to be executed;

(b) Any and all securities or commodities or contracts relating thereto, held by Merrill Lynch, were to be held as security for the payment of any of NMT's liabilities to Merrill Lynch;

(c) Merrill Lynch would have the right, whenever in its discretion it considered it necessary for its protection, to sell any of the commodities or contracts related thereto or to close out any standing commodities or contracts related thereto on the open market or on any exchange, without notice, demand, or advertisement;

(d) NMT would be at all times liable for deficiencies remaining in its account after sales by Merrill Lynch or NMT.

NMT also executed a power of attorney constituting and appointing Hanseatic as NMT's agent for the purpose of buying, selling, and trading in commodities. As a condition for buying, selling, and trading in commodities, Merrill Lynch required that NMT deposit $100,000 in cash with it. This was a margin[5] requirement to protect Merrill Lynch and the various commodity exchanges from losses in NMT's commodities account.[6] NMT opened a Ready Assets account with Merrill Lynch, with an initial deposit of $100,000. NMT authorized Merrill Lynch,

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[5]Margin is the amount of money or collateral deposited by a client with the broker for the purpose of insuring the broker against loss on open futures contracts; it is not a part payment on a purchase, and does not represent a loan. If a customer's "equity" in any futures contract drops to or under a specified percentage of the original margin (the equity percentage) the broker must issue a margin call (variation margin) to restore the equity percentage. Equity is the residual dollar value of a customer's total futures trading account assuming it were liquidated at current market prices.

[6]Pursuant to the rules of the various commodity exchanges, the broker effecting orders is primarily responsible to the various commodity exchanges for the trading losses of its customers.

in writing, to transfer funds from its Ready Assets account to its commodity account.

During its taxable year ended April 30, 1979, NMT, acting as a commodities trader, effected a number of futures transactions in commodities that included lumber, gold, hogs, copper, sugar, soybean oil, silver, soybeans, cotton, wheat, foreign currency, and cattle. NMT entered into commodities futures contracts with an aggregate cost price of $880,882. In order to close its positions, NMT entered into offsetting commodity futures contracts with respect to the same underlying commodities in the same delivery months with an aggregate selling price of $909,471.60. NMT realized total gains, before fees or commissions, of $28,590 from its commodity futures transactions. NMT did not engage in any straddle transactions.[7] At no time during its taxable year ended on April 30, 1979, did NMT have possession, nor did it take delivery of, any underlying commodities in connection with its commodity futures transactions.

For each transaction entered into by NMT, Merrill Lynch issued a transaction statement describing the transaction and setting forth the type of underlying commodity, the number of contracts purchased or sold, the selling price or cost of the underlying commodity (per contract unit), and the delivery month.

The chart on pages 1296–1297 reflects the delivery date, description, date of purchase, date of sale, selling price, cost, and gain or loss on the commodity futures transactions entered into by NMT during its taxable year ended April 30, 1979.

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[7] A commodity straddle is defined as the simultaneous holding of a long position in one delivery month and a short position in another delivery month. The long position and the short position are commonly referred to as the "legs" of the straddle. A straddle may be achieved in one or two ways: (1) By trading each leg separately, or (2) by taking both positions in one simultaneous transaction. Outright long or short positions in commodity futures are much more risky than straddle positions. The risk in an outright position is that the price of the underlying commodity will rise or fall. In a straddle position, the risk (potential for profit or loss) is that the spread or difference between the prices of the two legs of the straddle will widen or narrow; the general trend of the price of the underlying commodity is of no serious economic importance.

Delivery date	*Description*	*Date purchased*	*Date sold*	*Selling price*[8]	*Cost*[9]	*Gain or (loss)*[10]
8/78	Jan. 1979, Soybeans	8/14/78	8/28/78	$32,050.00	$31,525.00	$525.00
8/78	Dec. 1978, SB Meal	8/15/78	8/29/78	16,850.00	16,650.00	200.00
8/78	Dec. 1978, Cattle new	8/25/78	9/15/78	22,750.00	21,760.00	990.00
8/78	Dec. 1978, Cattle new	8/25/78	9/15/78	22,750.00	21,830.00	920.00
8/78	Mar. 1979, Wheat	8/24/78	10/20/78	16,987.50	16,487.50	500.00
8/78	Mar. 1979, Wheat	8/24/78	10/20/78	16,987.50	16,375.00	612.50
8/78	Dec. 1978, Hogs	8/25/78	9/20/78	15,000.00	14,257.50	742.50
8/78	Dec. 1978, Hogs	8/25/78	9/20/78	15,015.00	14,400.00	615.00
8/78	Mar. 1979, Sugar II	8/31/78	10/31/78	10,505.60	9,072.00	1,433.60
9/78	Dec. 1978, Copper	9/18/78	10/16/78	16,750.00	16,650.00	100.00
9/78	Dec. 1978, Deutsche marks	9/18/78	10/31/78	72,050.00	64,325.00	7,725.00
9/78	Dec. 1978, IMM gold	9/20/78	10/20/78	22,980.00	21,910.00	1,070.00
9/78	Dec. 1978, IMM gold	9/20/78	10/20/78	22,980.00	21,800.00	1,180.00
9/78	Dec. 1978, Swiss francs	9/25/78	9/26/78	85,850.00	85,000.00	850.00
9/78	Dec. 1978, Canadian oil	10/04/78	9/28/78	84,850.00	84,640.00	210.00

(Footnotes appear at end of table.)

Delivery date	*Description*	*Date purchased*	*Date sold*	*Selling price*	*Cost*	*Gain or (loss)*
10/78	Mar. 1979, Corn	10/02/78		47,400.00	47,250.00	150.00
10/78	Dec. 1978, Cotton	10/03/78	11/01/78	33,700.00	33,060.00	640.00
10/78	Jan. 1979, Soybeans	10/04/78	10/20/78	34,050.00	33,975.00	75.00
10/78	Dec. 1978, Silver	10/04/78	10/20/78	29,550.00	29,450.00	100.00
10/78	Dec. 1978, British pounds	10/12/78	10/31/78	51,450.00	49,575.00	1,875.00
10/78	Dec. 1978, IMM gold	10/25/78	10/31/78	24,120.00	23,410.00	710.00
10/78	Mar. 1979, IMM gold	10/27/78	10/31/78	24,730.00	24,590.00	140.00
11/78	Jan. 1979, Lumber	11/04/78	11/06/78	20,400.00	20,000.00	400.00
11/78	Jan. 1979, Soybean oil	11/21/78	11/08/78	14,706.00	14,580.00	126.00
11/78	Mar. 1979, IMM gold	11/21/78	11/10/78	21,350.00	20,610.00	740.00
11/78	Feb. 1979, Hogs	11/16/78	11/28/78	15,705.00	15,480.00	225.00
11/78	Feb. 1979, Cattle new	11/16/78	11/28/78	23,140.00	22,940.00	200.00
11/78	Feb. 1979, Cattle new	11/16/78	11/28/78	23,220.00	23,030.00	190.00
11/78	Mar. 1979, Japanese yen	11/21/78	11/16/78	67,187.50	66,250.00	937.50
9/78	Dec. 1979, Swiss francs		9/22/78	[11]	[11]	4,407.50
	Total commodity gains before commission			[12]909,471.60	880,882.00	28,589.60

[8]"Selling price" means the market price of the underlying commodity that is the subject of a commodity futures contract, on the date of the sale of the commodity futures contract.

[9]"Cost" means the market price of the underlying commodity that is the subject of a commodity futures contract, on the date that the commodity futures contract is entered into.

[10]"Gain" or "loss" is the difference between the selling price and the cost, before fees and commissions.

[11]The missing selling price and cost figures are not in evidence.

[12]This figure was stipulated by the parties, although the addition is not arithmetically correct. See note 11.

NMT received $35,000 in cash payments, attributable to the sale of the Bernalillo land, and $125,000,[13] attributable to the sale of the Baca location during its taxable year ended April 30, 1979. NMT also sold a D7 cat tractor on September 21, 1978, for $9,600 in cash, and office furniture for $40 in cash. The total of such items, other than interest, was $149,140. NMT had passive investment income in the amount of $92,726 during its taxable year ended April 30, 1979.[14]

All of the aforesaid transactions were reported on Form 1120S, U.S. Small Business Corporation Income Tax Return, for NMT's taxable year ended April 30, 1979. NMT was completely liquidated and dissolved in 1982.

Respondent determined, in his statutory notices of deficiency, that NMT derived "gross receipts," within the meaning of section 1372(e)(5), from its commodity futures transactions in the amount of $28,590—the difference between the contract price of the commodity futures contracts entered into by NMT in order to close or offset its open positions ($909,471.60) and the contract price of the commodity futures contracts ($880,882), rounded to the nearest dollar—during its taxable year ended April 30, 1979. Based upon the aforesaid interpretation of "gross receipts," within the meaning of section 1372(e)(5), respondent determined that NMT had gross receipts for its taxable year ended April 30, 1979, more than 20 percent of which was passive investment income.[15] Respondent, con-

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[13]Payment of principal with respect to the sale of the Baca location amounted to $104,500; $20,500 was interest.

[14]Computed as follows:

Interest on U.S. obligations	$953
Other interest	90,012
Oil royalties	1,761
Total	92,726

The $90,012 of "other interest" includes the portion of the installment payment on the sale of the Baca location attributable to interest ($20,500).

[15]The computation is as follows:

Gross receipts:	
Principal collections—installment sale (Baca location)	$104,500
Principal collections—installment sale (Bernalillo land)	35,000
Sale of D7 cat tractor	9,600
Sale of office furniture	40
Commodity futures transactions—gains before commissions	28,590
Interest on U.S. obligations	953
Other interest	90,012
Oil royalties	1,761
Total gross receipts	270,456

cluding that NMT's election to be taxed as a tax-option corporation under section 1372(a) was involuntarily terminated as of May 1, 1978, pursuant to the provisions of section 1372(e)(5), determined the deficiencies here in issue.

Included were respondent's determinations that: (1) NMT was a personal holding company in 1979; and (2) that the distributions of $100,000 and $197,844 that T.P. received from NMT during his taxable years ended December 31, 1979, and December 31, 1980, respectively, were taxable dividends under sections 301 and 316. The parties do not address the above-mentioned determinations directly, but have stipulated that: (1) Should this Court determine that "gross receipts," within the meaning of sec. 1372(e)(5), equals the amount realized by a small business corporation trading in commodity futures contracts, as contended by petitioners, the statutory notices of deficiency are erroneous as to all matters for all years in issue, and; (2) should this Court determine that "gross receipts," within the meaning of sec. 1372(e)(5), includes only gains from transactions in commodity futures contracts, unreduced by any fees or commissions, as contended by respondent, the statutory notices of deficiency are correct as to all matters for all years in issue. The parties agreed, further, that the issue herein is to be decided on the facts and the law as they existed in NMT's taxable year ended April 30, 1979.

ULTIMATE FINDING OF FACT

In its taxable year 1979, NMT had gross receipts less than 20 percent of which constituted passive investment income.

OPINION

Petitioners contend that "gross receipts," within the meaning of section 1372(e)(5), derived by a small business corporation from commodity futures transactions include the full

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Passive investment income:	
Interest on U.S. obligations	$953
Other interest	90,012
Oil royalties	1,761
Total passive investment income	92,726

Passive investment income ($92,726) is more than 20 percent of gross receipts ($270,456), or $54,091.20.

amount realized from such transactions, viz, the contract price of the offsetting futures contracts.

Respondent determined, in his notices of deficiency, that gross receipts from commodity futures transactions equal the amount of gain resulting from the difference between the total contract prices of the offsetting short positions and the total contract prices of the long positions, unreduced by any fees or commissions.[16]

The issue before us appears to be one of first impression in the Federal courts, including this Court.

Commodity futures contracts are executory contracts that encompass both rights and obligations with respect to property. *Covington v. Commissioner*, 42 B.T.A. 601 (1940), affd. on this issue 120 F.2d 768 (5th Cir. 1941), cert. denied 315 U.S. 822 (1942). A commodity futures contract does not represent the commodity itself, but rather the right to acquire the specific commodity. *Modesto Dry Yard, Inc. v. Commissioner*, 14 T.C. 374 (1950). The person initiating a commodity futures contract acquires either the right and obligation to purchase the underlying commodity in the future (a long position) or the right and obligation to sell the underlying commodity in the future (a short position), in each case, at a fixed price. A long or short commodity futures position is acquired when a long or short position is traded by a broker over a recognized commodity exchange and recorded on the exchange's books. *Smith v. Commissioner*, 78 T.C. 350 (1982); see *Valley Waste Mills v. Page*, 115 F.2d 466 (5th Cir. 1940), cert. denied 312 U.S. 681 (1941); *Maloney v. Commissioner*, 25 T.C. 1219 (1956). In order for a party to a commodity futures contract to terminate the contractual rights and obligations prior to delivery, a closing or setoff transaction is required.[17] Settlement of a commodity futures contract by offset constitutes a sale or exchange of the original commodity futures contract. *Vickers v. Commissioner*, 80 T.C. 394 (1983); *Covington v. Commissioner*, *supra*; see

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[16] Based upon the aforesaid interpretation of "gross receipts," within the meaning of sec. 1372(e)(5), respondent determined that NMT's election under sec. 1372(a) was involuntarily terminated as of May 1, 1978, pursuant to sec. 1372(e)(5), because NMT had gross receipts for its taxable year ended Apr. 30, 1979, more than 20 percent of which was passive investment income. See Rev. Rul. 79-294, 1979-2 C.B. 305, which states respondent's position on this issue.

[17] A closing or offsetting transaction involves the acquisition of either a long position (if the trader wishes to liquidate a short position) or a short position (if the trader wishes to liquidate a long position) covering the same amount of a specified commodity and the same delivery month.

Hoover Co. v. Commissioner, 72 T.C. 206 (1979); *Battelle v. Commissioner*, 47 B.T.A. 117 (1942). Accordingly, gain or loss is sustained at the time of settlement of a commodity futures contract by offset.[18] See *Smith v. Commissioner*, *supra*.

The amount realized from the sale or other disposition of property is the sum of any money received plus the fair market value of the property (other than money) received. Sec. 1001(b); sec. 1.1001–1(a), Income Tax Regs. The amount of gain or loss realized from the settlement of a commodity futures contract by offset is the difference between the contract price of the offsetting short (if a long position was originally entered into), or long (if a short position was originally entered into) position and the contract price of the original commodity futures contract.[19]

Section 1372(a) provides for an election, available to eligible small business corporations, not to be subject to the taxes imposed by chapter 1,[20] but to have all its income taxed directly to its shareholders. Once validly made, such election is effective for the taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation unless it is terminated or revoked under section 1372(e). Sec. 1372(d). Section 1372(e)(5) provides, in pertinent part, as follows:

(5) PASSIVE INVESTMENT INCOME.—

(A) Except as provided in subparagraph (B), an election under subsection (a) made by a small business corporation shall terminate if, for any taxable year of the corporation for which the election is in effect, such corporation has gross receipts more than 20 percent of which is passive investment income. Such termination shall be effective for the taxable year of the

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[18] NMT did not sustain any losses as a result of its trading in commodity futures contracts, only gains.

[19] For example, on Sept. 20, 1978, NMT entered into a contract to accept delivery of IMM gold in December 1978 (long position). The price per ounce of gold as of this date was $218; the contract involved 100 ounces. The price per ounce of gold on Oct. 20, 1978, was $229.80, and NMT on that date entered into a contract to deliver IMM gold in December 1978 at $229.80 per ounce (short position). The acquisition of a short position in the same commodity for the same delivery month, viz, the entering into an offsetting short contract, constitutes a sale or exchange in which a gain of $1,180 was realized, as follows: amount realized is the contract price of the short contract ($22,980) less the contract price of the long contract ($21,800), equals gain of $1,180 before fees or commissions.

[20] These taxes include the regular corporate income tax, the accumulated earnings tax, and the personal holding company tax. However, pursuant to sec. 1372(b), an electing small business corporation which realizes capital gains may be subject to the special capital gains tax imposed by sec. 1378 and the minimum tax of secs. 56 and 58(d)(2).

corporation in which it has gross receipts of such amount, and for all succeeding taxable years of the corporation.

* * * * * * *

(C) For purposes of this paragraph, the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of the gains therefrom). * * *

The subchapter S provisions do not contain a definition of the term "gross receipts." Section 1.1372–4(b)(5)(iv), Income Tax Regs., defines gross receipts as follows:

The term "gross receipts" as used in section 1372(e) is not synonymous with "gross income." The test under section 1372(e)(4) and (5) shall be made on the basis of total gross receipts, except that, for purposes of section 1372(e)(5), gross receipts from the sales or exchanges of stock or securities shall be taken into account only to the extent of the gains therefrom. The term "gross receipts" means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income. Thus, the total amount of receipts is not reduced by returns and allowances, cost, or deductions. For example, gross receipts will include the total amount received or accrued during the corporation's taxable year from the sale or exchange (including a sale or exchange to which section 337 applies) of any kind of property, from investments, and for services rendered by the corporation. However, gross receipts does not include (1) amounts received in nontaxable sales or exchanges (other than those to which 337 applies), except to the extent that gain is recognized by the corporation, (2) amounts received as a loan, as a repayment of a loan, as a contribution to capital, or on the issuance by the corporation of its own stock, or (3) certain amounts which are treated under section 331 (relating to corporate liquidations) as payments in exchange for stock (see subdivision (xi) of this subparagraph).

Section 1372(e)(5) was enacted as part of section 64, Technical Amendments Act of 1958, Pub. L. 85–866, 72 Stat. 1606, 1652 (1958), which amended chapter 1 by adding subchapter S, composed of sections 1371 through 1377.[21] As originally enacted in 1958, section 1372(e)(5) provided as follows:

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[21] In 1954, President Eisenhower recommended the passage of legislation which would eliminate the influence of Federal tax laws on the selection of the form of organization adopted by small businesses. President's Budget Message of Jan. 21, 1954, 100 Cong. Rec. 567, 571 (1954). In the same year, the Senate acted upon the President's proposal; sec. 1351 of the bill passed by the Senate would have allowed certain corporations to be taxed as partnerships and certain proprietorships and partnerships to be taxed as corporations. The companion bill reported by the House Ways and Means Committee did not contain any such provision and the Conference

(5) PERSONAL HOLDING COMPANY INCOME.—An election under subsection (a) made by a small business corporation shall terminate if, for any taxable year of the corporation for which the election is in effect, such corporation has gross receipts more than 20 percent of which is derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom). Such termination shall be effective for the taxable year of the corporation in which it has gross receipts of such amount, and for all succeeding taxable years of the corporation.

Subsection (a) of section 3 of the Act of April 14, 1966, Pub. L. 89–389, 80 Stat. 114–115, amended section 1372(e)(5) by changing the heading of paragraph (5) from "Personal holding company income" to "Passive investment income," and by dividing the paragraph into subparagraphs (A), (B), and (C).[22]

Respondent does not contend that gross receipts from dealing in commodities futures are passive investment income for purposes of section 1372(e)(5).[23] Rather, respondent's con-

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Committee approved only the provision allowing proprietorships and partnerships to elect to be taxed as corporations. Conf. Rept. 2543, 83d Cong., 2d Sess. 72 (1954). In 1958, President Eisenhower again recommended that Congress adopt certain tax provisions to help small businesses. President's Budget Message of Jan. 13, 1958, 104 Cong. Rec. 388, 389 (1958). In the same year, the Treasury Department drafted provisions for the consideration of the House Ways and Means Committee. The House Committee did not adopt the Treasury's draft in any form. H. Rept. 775, 85th Cong., 1st Sess. (1957), 1958–3 C.B. 811. However, the Senate developed subch. S, which Congress adopted in the Technical Amendments Act of 1958. S. Rept. 1983, to accompany H.R. 8381 (Pub. L. 85–866), 85th Cong., 2d Sess. (1958), 1958–3 C.B. 922, 1008.

[22] Subsec. (b) of sec. 3 of the Act of Apr. 14, 1966, Pub. L. 89–389, 80 Stat. 111, 114, made the amendment in subsec. (a) generally applicable to taxable years of electing small business corporations ending after the date of enactment of the act.

[23] Sec. 1372(e)(5)(C) provides that the term "passive investment income" means six types of gross receipts. The term "means" indicates an exclusive list. The sole type of income which can reasonably be considered to include commodity futures transactions is gross receipts derived from sales or exchange of stock or securities. Sec. 1.543–1(b)(5)(i), Income Tax Regs., defines stock or securities. Sec. 1.543–1(b)(5)(i), Income Tax Regs., is applied to subch. S by sec. 1.1372–4(b)(5)(x), Income Tax Regs. Sec. 1.543–1(b)(5)(i), Income Tax Regs., provides in pertinent part, as follows:

"The term 'stock or securities' as used in section 543(a)(2) and this subparagraph includes shares or certificates of stock, stock rights or warrants, or interest in any corporation (including any joint stock company, insurance company, association, or other organization classified as a corporation by the Code, certificates of interest or participation in any profit sharing agreement, or in any oil, gas, or other mineral property, or lease, collateral trust certificates, voting trust certificates, bonds, debentures, certificates of indebtedness, notes, car trust certificates, bills of exchange, obligations issued by or on behalf of a State, Territory, or political subdivision thereof."

Thus, commodity futures contracts are not stock or securities. Rev. Rul. 71–568, 1971–2 C.B. 312, so holds. See also Rev. Rul. 72–457, 1972–2 C.B. 510 (income derived by an electing small business corporation from the buying and selling of commodity futures is not passive investment income within the meaning of sec. 1372(e)(5)); *Corn Products Refining Co. v. Commissioner*, 215 F.2d 513 (3d Cir. 1954), affg. on this issue 16 T.C. 395 (1951), affd. on another ground 350 U.S. 46 (1955) (commodity futures do not constitute stock or securities within the meaning of the wash sale provisions of the Code—currently sec. 1091).

tention is that section 1372(e)(5) requires that only the gains realized by a small business corporation from its commodity futures transactions be included in determining whether the corporation had gross receipts more than 20 percent of which constitute passive investment income. Respondent argues, in support of his contention, that: (1) The legislative history of section 1372(e)(5) and the Federal statutory scheme in subchapter S indicate that only gains from commodity futures transactions were intended by Congress to be used in computing gross receipts;[24] (2) the intent that only gains from these transactions be included is evidenced by the parenthetical "(gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains)" in section 1372(e)(5)(C); (3) NMT's primary purpose in trading in commodity futures was to avoid the automatic termination provision in section 1372(e)(5); (4) NMT's monetary obligation and risk and loss with respect to its commodity futures transaction was limited to the amount of the margin deposits, and not to the full amount of the contract price of the commodity futures contract, thus the amount realized is only the gain ($28,589.60) excluding the "debt relief" (total contract prices of original commodity futures contracts, $880,882).

Respondent's arguments are not supported by the scant legislative history of the subchapter S provisions. Section 1372(e)(5) was amended in 1966 by section 3(a) of Pub. L. 89–389, 80 Stat. 111, 114, which changed the title of the aforesaid section from "Personal holding company income" to

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[24] Respondent's reasoning is as follows: (1) Sec. 351 of the Revenue Act of 1934, 48 Stat. 630, 751 imposed a special tax on undistributed profit of personal holding corporations, defined a corporations 80 percent of whose gross income for the taxable year consisted of royalties dividends, interest, annuities, and (except in the case of regular dealers in stock or securities) gai from the sale or exchange of stock or securities, and whose stock to the extent of more than 5 percent in value was owned by not more than five individuals at any time during the last half the taxable year; (2) in order that individuals could not take advantage of the personal holdin company provisions so as to reduce their taxes, sec. 1 of the Revenue Act of 1937, 50 Stat. 813, w enacted, adding new sec. 353 (the predecessor of sec. 543), which included as personal holdi company income the gains from commodity futures transactions on or subject to the rules boards of trade and exchanges (an exception was made in the case of gains on bona fide hedgi transactions derived by corporations engaged in producing, processing, merchandising, handling such commodities). This provision was included as sec. 502(c) of the 1939 Code; it w further enacted as sec. 543(a)(3) of the 1954 Code; and (3) at the time sec. 1372(e)(5) was enacted 1958, the aforesaid version of sec. 543(a)(3) (including commodity gains within the definition "personal holding company income") was in effect. Thus respondent concludes, in entitli 1372(e)(5) "Personal holding company income" in 1958, Congress expected and anticipated th only the gains from commodity futures transactions would be included for purposes of computi gross receipts from the closing or setoff of commodity futures contracts.

"Passive investment income." Thus, even if respondent is correct that the original version of section 1372(e)(5) intended to incorporate by reference the provisions of the Code referring to the personal holding companies, the amendment of section 1372(e)(5) by section 3(a) of Pub. L. 89–389, 80 Stat. 111, 114, changing the heading of paragraph (5), constitutes a calculated effort by Congress to erase utterly any implication that a small business corporation must be a personal holding company before it can be excluded from subchapter S treatment by section 1372(e)(5). See *Marshall v. Commissioner*, 510 F.2d 259 (10th Cir. 1975), affg. 60 T.C. 242 (1973). Section 543 was also amended by section 225(d) of the Revenue Act of 1964, Pub. L. 88–272, 78 Stat. 19, 81, which deleted the provisions of paragraph (3) of subsection (a), including gains from commodity futures transactions within the definition of personal holding company income, from the definition of personal holding company income.

Respondent's contention that the parenthetical in section 1372(e)(5)(C) requires that only gains from commodity futures transactions be included as "gross receipts," is also meritless. The aforesaid parenthetical, by its terms, refers exclusively to sales or exchanges of stock or securities.[25]

Respondent contends, further, that NMT became a trader in commodity futures in order to avoid the automatic termination provision of 1372(e)(5). NMT, respondent's argument goes, was an active lumber corporation in the lumber business until 1976, when it decided to fully liquidate and cease its active business, and sold substantial portions of its assets under the installment method provisions of section 453. NMT found it advantageous, from a tax standpoint, to maintain its subchapter S status until the final installment payments from the sale of its assets were received. NMT's transactions in commodity futures contracts provided a source of nonpassive investment income necessary to avoid termination of its subchapter S corporation status under section 1372(e)(5).

The spell of the "active" trade of business requirement has been invoked, in the context of the subchapter S provisions, on innumerable occasions.[26] See, e.g. *Buono v. Commissioner*, 74

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[25] Commodity futures contracts are not stock or securities. See note 22 *supra*.

[26] In support of this argument, the legislative history of the subch. S provisions, specifically S. Rept. 1007, 89th Cong., 2d Sess. (1966), 1966–1 C.B. 532, which states that the subch. S provisions

T.C. 187 (1980); *Marshall v. Commissioner*, *supra*; *Howell v. Commissioner*, 57 T.C. 546 (1972); *Buhler Mortgage Co. v. Commissioner*, 51 T.C. 971 (1969), affd. per curiam 443 F.2d 1362 (9th Cir. 1971). Section 1372(e)(5) requires the application of an objective test in determining whether a small business corporation's election under section 1372(a) has been terminated.[27] Although we agree with respondent that the subchapter S provisions were not intended to include corporations with large amounts of investment-type income (as opposed to those actively engaging in a trade or business), we also think that the standard used by the Code and the regulations does not permit us to look behind the normal characterization of a corporation's receipts in order to classify them as active or passive. See *Buhler Mortgage Co. v. Commissioner*, *supra*. Section 1372(e)(5) clearly specifies the types of potentially disqualifying passive investment income; gross receipts from transactions in commodity futures contracts are not among them. Furthermore, this Court has previously held that there is nothing unique or improper about a corporation engaging in exclusively investment activity, including under this rubric a subchapter S corporation. *Buono v. Commissioner*, *supra*; *Howell v. Commissioner*, *supra*. "[I]t has been black letter law ever since *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943), that a corporation is, almost by definition, an entity engaged in 'business activity.'" *Buono v. Commissioner*, 74 T.C. at 197.

Finally, respondent argues that Merrill Lynch, not NMT, was primarily obligated for any losses sustained in NMT's commodity account; that liability or debt potential as a trader was limited on any day before the delivery month with respect to each commodity contract to the margin call on that particular day, and not to the purchase price of the futures contract. Thus, when NMT closed out a futures contract by entering into an offsetting position, it was not relieved of any real and present debt includable in its amount realized.

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were passed to allow only small businesses actively engaged in a trade or business to make the election, is usually relied upon. Those businesses with large amounts of passive income were not to have the option of electing subch. S treatment. Consequently, Congress denied the election to those corporations which had large amounts of investment type income such as royalties, rents, dividends, annuities, and profits from the sales or exchanges of stock and securities.

[27] Respondent stipulated that NMT decided to attempt to make profits by trading in commodity futures contracts.

The parties stipulated, and we found as a fact, that when a commodity futures contract is entered into, the parties commit themselves to deliver, and accept delivery of, or to accept delivery of, and deliver, a specified commodity during a designated delivery month, and at a specified price. In order to acquire the contractual rights and incur the obligations in a futures transaction, an initial margin deposit is generally required. Should the trader's equity drop,[28] an additional margin call may be issued by the broker in order to restore the equity percentage to the specified level. This in no way alters a trader's rights and obligations with respect to the commodity futures contract. It is clear from the record that NMT was ultimately responsible to Merrill Lynch for any losses incurred in its commodity futures transactions.

Therefore, when commodity futures contracts are settled by offset, the contract price of the offsetting position, as determined by the market value of the underlying commodity, constitutes the amount realized, without being limited to the amount of gain. Thus, "gross receipts," within the meaning of section 1372(e)(5), means the *total* amount received or accrued by the corporation under its method of accounting in computing its taxable income without reduction for fees or commissions, and not simply gains, as contended by respondent.[29] We accordingly decide the issue presented in favor of petitioners and, as the parties have stipulated, it results from this that respondent's various determinations against petitioners were in error.

In order to allow the parties to submit computations as to the amount of the overpayment that is due to the petitioners,[30]

Decision will be entered under Rule 155.

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[28]For example, where the trader acquires a long position and the price of the underlying commodity falls.

[29]Both parties discuss the rationale of our decision in *Smith v. Commissioner*, 78 T.C. 350 (1982), in extenso. In *Smith v. Commissioner, supra*, we dealt with the deductibility of losses incurred in silver tax straddle transactions. Thus, the facts of *Smith v. Commissioner, supra*, are distinguishable and merit no further discussion here.

[30]In their petition herein, petitioners alleged that they paid in full the deficiencies determined by respondent after the issuance of the statutory notices herein, but prior to the filing of the petition, and accordingly prayed for the entry of a decision finding an overpayment of taxes in such amounts. In his answer, respondent denied petitioners' allegations "for lack of knowledge." The record is otherwise silent. The parties should be able to agree on this matter as part of an agreed recomputation to be presented to the Court under Rule 155. If not, further proceedings under Rule 155 may be necessary.

RICHARD L. ABRAMS, ET AL.,[1] PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 2645-85. Filed June 17, 1985.

A pre-filing notification letter was sent by a District Director for respondent to each taxpayer who had invested in a certain tax shelter. The letter stated that the taxpayer's return would be reviewed and any deductions taken in regard to the shelter would be disallowed, with consideration given to the determination of appropriate "penalties." The taxpayers filed a consolidated petition with this Court on the ground that the pre-filing notification letter constitutes a notice of deficiency. Respondent filed a motion to dismiss for lack of jurisdiction. *Held*: The pre-filing notification letter is not a notice of deficiency within the meaning of secs. 6212(a) and 6213(a), I.R.C. 1954. Therefore, this Court lacks jurisdiction. Respondent's motion will be granted.

Martin A. Schainbaum and *Kathleen A. Miller*, for the petitioners.

Kathleen E. Whatley and *Elizabeth I. Abreu*, for the respondent.

OPINION

DAWSON, *Judge*: This case is before the Court on respondent's motion to dismiss for lack of jurisdiction filed on April 4, 1985. Without a hearing, an order was entered on April 12, 1985, granting respondent's motion. This order was vacated and set aside on April 16, 1985, and a hearing on the motion was held on May 22, 1985, at the motions session in Washington, D.C. The parties filed memoranda of points and authorities. After considering the memoranda and the arguments made by the parties at the hearing, the Court took respondent's motion under advisement.

On November 2, 1984, the District Director of the Laguna Niguel District sent a letter to each of the petitioners herein which provided, in pertinent part, as follows:

Re: Liberty Financial 1983 Government
Securities Trading Strategy

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[1] There are 110 additional petitioners listed in the caption of the consolidated petition filed in this case.

Dear Taxpayer:

Our information indicates that you invested in the above tax shelter during the above tax year. Based upon our review of that promotion, we believe that the purported tax deductions and/or credits are not allowable.

We plan to review your return to determine whether you claimed such deductions and/or credits. If you did so, we will examine your return and reduce the portion of any refund due to you which is attributable to the above tax shelter promotion. If an examination results in adjustments to your return, you will be afforded the opportunity to exercise your appeal rights. The Internal Revenue Code provides, in appropriate cases, for the application of the negligence penalty under section 6653(a), the overvaluation penalty under section 6659 and/or the substantial understatement of income tax penalty under section 6661 of the Internal Revenue Code and other appropriate penalties. Our examination will determine whether these penalties are appropriate. See the back of this letter for an explanation of these penalties.

If you claimed deductions and/or credits on a return already filed, you may wish to file an amended tax return.

The letter was signed by the District Director.

In response to such letters, petitioners, on January 28, 1985, filed a consolidated petition in this Court. They contend that the letters are notices of deficiencies because the language indicates that any deductions taken with respect to Liberty Financial Government Securities Trading Strategy would be disallowed. As support for their contention, petitioners argue that all respondent needs to to is to make a mathematical computation. Hence, they assert that the prerequisites for invoking the jurisdiction of this Court were satisfied when they filed a timely petition in this case.[2]

Respondent explains that the issuance of pre-filing notification (PFN) letters is a practice begun by the Internal Revenue Service to combat the increasing number of abusive tax shelters. See Rev. Proc. 83–78, sec. 6.02, 1983–2 C.B. 595, 597; Rev. Proc. 84–84, sec. 3.01, 1984–52 I.R.B. 77–78. He contends that the PFN letter sent to each of the petitioners is not a notice of deficiency because the letter does not set forth an amount of tax due or make a final determination, citing *Foster v. Commissioner*, 80 T.C. 34, 229–230 (1983), affd. on this issue 756 F.2d 1430 (9th Cir. 1985), and *Scar v. Commissioner*, 81 T.C. 855, 860–861 (1983). He argues that the letter does not purport, nor was it intended, to be a notice of deficiency.

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[2]Petitioners have presented other arguments that we have not addressed because we view them as tangential to the crucial issue of whether the letters they received are notices of deficiencies.

Section 6212(a)[3] authorizes the issuance of a notice of deficiency. No particular form is required. *Scar v. Commissioner*, *supra* at 860; *Jarvis v. Commissioner*, 78 T.C. 646, 655–656 (1982). However, the notice must fulfill the purpose of providing formal notification that a deficiency in tax has been determined. *Foster v. Commissioner*, *supra* at 229. The notice is "only to advise the person who is to pay the deficiency that the Commissioner means to assess him; anything that does this *unequivocally* is good enough." *Olsen v. Helvering*, 88 F.2d 650, 651 (2d Cir. 1937) (emphasis added). The notice must (1) advise the taxpayer that the Commissioner has, in fact, determined a deficiency, and (2) specify the year and the amount of the deficiency. *Foster v. Commissioner*, *supra* at 229–230.

The PFN letters do not satisfy these requirements. They do not rise to the level of notices of deficiencies. They do not state that they are notices of deficiencies. They do not state that a *determination* has been made.[4] They do not specify an amount. The language of the letters is tentative. It says that respondent *plans* to examine petitioners' returns in the event petitioners *claim* the specified deductions. And, as respondent has pointed out, the letters were not *intended*[5] to be notices of deficiencies. See *Lerer v. Commissioner*, 52 T.C. 358, 363–365 (1969).

We do not agree with petitioners that all that remains for respondent to do is to make a mathematical calculation.

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[3]Sec. 6212(a) provides as follows:

SEC. 6212(a). IN GENERAL.—If the Secretary determines that there is a deficiency in respect of any tax imposed by subtitle A or B or chapter 41, 42, 43, 44, or 45, he is authorized to send notice of such deficiency to the taxpayer by certified mail or registered mail.

All section references are to the Internal Revenue Code of 1954 as amended, unless otherwise indicated.

[4]See *Terminal Wine Co. v. Commissioner*, 1 B.T.A. 697, 701 (1925), where it was stated:

"The *determination* from which a taxpayer may appeal is one which fixes the amount of *deficiency* in tax. It is the final decision by which the controversy as to the deficiency is settled and terminated, and by which a final conclusion is reached relative thereto and the extent and measure of the deficiency defined."

[5]Petitioners argue that our opinion in *Scar v. Commissioner*, 81 T.C. 855 (1983), requires that the letters in this case be treated as notices of deficiencies. In *Scar*, the taxpayer received a letter that was *intended* by the Commissioner to be a notice of deficiency. The letter stated clearly that it was a notice of deficiency and that a determination had been made. The letter also provided an amount. The issue in *Scar* involved whether the notice was valid because of the errors contained in it. We held that the notice was valid because it was proper in form although it contained substantive errors. In contrast, the letters received by petitioners here were not intended by respondent to be notices of deficiencies. In addition, as stated previously, the letters did not purport to be notices of deficiencies and they did not state that a determination had been made nor did they provide an amount. We think our *Scar* opinion provides no support for petitioners' position in this case.

Subsequent to the issuance of the PFN letters, respondent may decide that other adjustments should be made to petitioners' returns and may even decide that petitioners are entitled to overpayments; or respondent may decide upon audit of the returns that *no* adjustments should be made. The bottom line is that respondent has not yet examined petitioners' returns and has not made any determination.

This case is not controlled by *Laing v. United States*, 423 U.S. 161 (1976). The Supreme Court held in *Laing* that taxpayers who are subject to a termination assessment must receive a notice of deficiency. It said that a taxpayer should be afforded access to the courts when the termination occurs because substantial rights are affected. Under section 6851, as it existed for the years covered by *Laing*, when a termination occurs, the taxpayer's taxable year is closed and the tax is due immediately. In sharp contrast, PFN letters have no immediate effect upon the substantial rights of petitioners except to warn them of the possible disallowance of deductions and to encourage them to reevaluate the propriety of any deductions they may claim.

In *Estate of Adamczyk v. Commissioner*, T.C. Memo. 1981–259, the taxpayers received a "30-day letter" which informed them of adjustments to their tax return. They were given the opportunity to agree to the adjustments, to provide additional information, or to request a conference. They were also informed that if they did not respond within 30 days, a notice of deficiency would be issued. This Court concluded that a 30-day letter merely proposes adjustments and is therefore not a notice of deficiency because it is not a final determination. PFN letters do not even rise to the level of a 30-day letter. They certainly do not constitute notices of deficiencies.

Accordingly, we hold that the pre-filing notification letters[6] in this case are not notices of deficiencies,[7] which are required

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[6] PFN letters were recently discussed in *Mid-South Music Corp. v. U.S. Dept. of the Treasury*, 579 F. Supp. 481 (M.D. Tenn. 1983). In that case, the taxpayer sued the Government and the District Director for civil damages. The taxpayer alleged that the issuance of a PFN letter was not procedurally correct and therefore deprived him of due process. It also alleged that the issuance of the letter violated the nondisclosure provisions of sec. 6103(a). The District Court granted the Government's motion to dismiss, stating that it was unaware of any provision in the Internal Revenue Code that precluded the issuance of PFN letters, and that the letters were a reasonable method utilized by the Secretary as part of his broad latitude to collect taxes.

[7] To hold otherwise would open the floodgates for almost any communication between the Internal Revenue Service and a taxpayer to be treated as a notice of deficiency. With regard to

by sections 6212(a) and 6213(a) as prerequisites to this Court's jurisdiction. Therefore, we will grant respondent's motion to dismiss for lack of jurisdiction.

An appropriate order will be entered.

DANIEL C. PEACH, JR., AND PEGGY B. PEACH, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 19718-84. Filed June 20, 1985.

Held:
1. Sec. 1.44C-2(h), Income Tax Regs., is valid;
2. The retroactive application of sec. 1.44C-2(h), Income Tax Regs., is not arbitrary as a general matter or as applied to petitioners; and
3. Statements in I.R.S. Publications 17 and 903, properly interpreted, are not contrary to the provisions of sec. 1.44C-2(h), Income Tax Regs.

Daniel C. Peach, Jr., pro se.

Willard N. Timm, Jr., and *Todd K. Snyder*, for the respondent.

OPINION

SCOTT, *Judge*: This case is before us on respondent's motion for summary judgment. The issue raised by respondent's motion is whether petitioners are entitled to an energy tax credit with respect to a water-source heat pump installed in 1980.

At the hearing on respondent's motion, the parties agreed to all the facts necessary to a decision of the issue presented here. Since there is no issue of material fact in this case, its disposition on the basis of respondent's motion for summary judgment is appropriate. Rule 121(b), Tax Court Rules of Practice and Procedure; *Espinoza v. Commissioner*, 78 T.C. 412 (1982).

PFN letters alone, as of Apr. 30, 1985, approximately 22,629 have been issued by the Internal Revenue Service.

Respondent determined a deficiency in petitioners' income tax for the calendar year 1980 in the amount of $1,672.

The agreed facts in this case show that petitioners resided in Great Falls, South Carolina, at the time of the filing of their petition in this case. They filed a joint Federal income tax return for the calendar year 1980 with the Internal Revenue Service Center, Atlanta, Georgia.

In the spring of 1980, Mr. Peach (petitioner) began consideration of installing a water-source heat pump (sometimes referred to as a ground water heat pump) to produce a source of energy to heat and cool petitioners' residence. On August 21, 1980, petitioner placed a firm order for the heat pump and the materials necessary for its installation. Later that year, the heat pump was installed. This heat pump is one which pumps water from a well. The year-round temperature of the water used in the system installed by petitioners is 15.56 degrees to 18.33 degrees Celsius (60 degrees to 65 degrees Fahrenheit). At the time petitioners purchased the heat pump for heating and cooling purposes in their home, the suppliers of such heat pumps were advertising that a person would be entitled to an energy tax credit with respect to the heat pump if it was used with a geothermal well water system. Petitioner asked someone at the Internal Revenue Service (IRS) whether the equipment he was considering purchasing, which he described to the individual with whom he spoke, would qualify for the energy tax credit. The individual at the IRS with whom petitioner spoke told him that no standards for equipment to be used with a geothermal well water system had been published and therefore the equipment he was considering purchasing should qualify. However, this individual suggested that petitioner read "Your Federal Income Tax," Publication 17. Petitioner obtained this publication, which referred the reader to IRS Publication 903 for a full explanation of the energy tax credit. Petitioner obtained the November 1979 revision of Publication 903. This publication contained the following statement which petitioner interpreted to entitle him to the energy tax credit with respect to the equipment he was contemplating buying:

> The renewable energy source property, to qualify, must be new, must be expected to last at least 5 years, and must meet certain performance and quality standards to be set by the Secretary of the Treasury. As of the date of

this publication, no performance and quality standards have been issued. However, the property does not have to meet the standards if you buy it before the standards are published. The cost of renewable energy source equipment includes labor cost properly allocable to the on-site preparation, assembly, or installation of the equipment.

* * * * * * *

Geothermal energy property is equipment that uses geothermal energy to heat or cool the home or to provide hot water for use within the home. This is done by distributing or using geothermal deposits. A geothermal deposit is a geothermal reservoir containing natural heat stored in rocks, water, or vapor. For example, hot springs are a geothermal deposit.

Petitioners, on their income tax return for the calendar year 1980, claimed a residential energy credit of $1,672. On the Form 5695, "Energy Credits," attached to their return, petitioners showed an amount of $6,368.21 as expended for "Renewable Energy Source items: b. Geothermal" with a resulting energy credit of $2,547.28. The claimed credit was limited to $1,672 since the amount of petitioners' income tax for 1980 shown on their return prior to reduction by the claimed energy tax credit was $1,672. At the bottom of the Form 5695 attached to petitioners' return, the statement "credit carryover 875.28" appears.

Respondent, in his notice of deficiency, disallowed the energy tax credit claimed by petitioners.

Section 44C (now section 23) of the Code[1] provides for a credit to be allowed to individuals for qualified expenditures after April 20, 1977, and prior to December 31, 1985, for property which, when installed in connection with a dwelling, transmits or uses geothermal deposits as defined in section 613(e)(3) for the purpose of heating or cooling such dwelling or providing hot water or electricity for use with such dwelling.[2]

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[1] Unless otherwise stated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the year here in issue.

[2] Sec. 44C(c)(5) and (6) provides in part:

(5) RENEWABLE ENERGY SOURCE PROPERTY.—The term "renewable energy source property" means property—

(A) which, when installed in connection with a dwelling, transmits or uses—

(i) solar energy, energy derived from the geothermal deposits (as defined in section 613(e)(3)), or any other form of renewable energy which the Secretary specifies by regulations, for the purpose of heating or cooling such dwelling or providing hot water or electricity for use within such dwelling, or

(ii) wind energy for nonbusiness residential purposes,

(B) the original use of which begins with the taxpayer,

The statute specifically provides that the Secretary shall by regulation establish the criteria which are to be used in prescribing performance and quality standards for renewable energy source property and to establish a procedure under which a manufacturer of an item may request the Secretary to certify that the item would be treated as renewable energy source property.

On May 23, 1979, proposed regulations with respect to renewable energy source property and the energy tax credit were published in the Federal Register (44 Fed. Reg. 29924 (1979)). Section 1.44C–2(e) of this proposed regulation described renewable energy source property insofar as here pertinent as follows:

(e) *Renewable energy source property*—(1) *In general.* The term "renewable energy source property" includes any solar energy property, wind energy property, geothermal energy property, or property referred to in subparagraph (2), which meets the following conditions:

(i) The original use of the property begins with the taxpayer.

(ii) The property can reasonably be expected to remain in operation for at least 5 years.

(iii) The property meets the applicable performance and quality standards prescribed in sec. 1.44C–4 (if any) that are in effect at the time of the taxpayer's acquisition of the property.

Section 1.44C–2(h) of these proposed regulations defined geothermal energy property. This section, which included a definition of a geothermal deposit, provided as follows:

(h) *Geothermal energy property.* The term "geothermal energy property" includes equipment (and parts solely related to the functioning of such equipment) necessary to transmit or use energy from a geothermal deposit to heat or cool a dwelling or provide hot water for use within the dwelling. Equipment such as a pipe that serves both a geothermal function (by transmitting hot geothermal water within a dwelling) and a non-geothermal

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(C) which can reasonably be expected to remain in operation for at least 5 years, and

(D) which meets the performance and quality standards (if any) which—

(i) have been prescribed by the Secretary by regulations, and

(ii) are in effect at the time of the acquisition of the property.

(6) REGULATIONS.—

(A) CRITERIA; CERTIFICATION PROCEDURES.—The Secretary shall by regulations—

(i) establish the criteria which are to be used in (I) prescribing performance and quality standards under paragraphs (3), (4), and (5), or (II) specifying any item under paragraph (4)(A)(viii) or any form of renewable energy under paragraph (5)(A)(i), and

(ii) establish a procedure under which a manufacturer of an item may request the Secretary to certify that the item will be treated, for purposes of this section, as insulation, an energy-conserving component, or renewable energy source property.

function (by transmitting hot water from a water heater within a dwelling) does not qualify as geothermal property. A geothermal deposit is a geothermal reservoir consisting of natural heat which is from an underground source and is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure), having a temperature exceeding 60 degrees Celsius as measured at the well head or, in the case of a natural hot spring (where no well is drilled), at the intake to the distribution system.

The final regulations with respect to the residential energy credit which apply to the year 1977 and all subsequent years, were promulgated on November 29, 1980. In T.D. 7717, 1980–2 C.B. 7, 9, the following appears with respect to a change made in the final regulations as compared to the proposed regulations defining geothermal energy property:

The residential energy credit applies to property which transmits or uses energy derived from a geothermal deposit to heat or cool a dwelling or provide hot water for use within the dwelling. Several comments suggested that the definition of geothermal deposit be revised either by deleting the 60 degrees Celsius temperature limitation or by lowering the temperature limitation. The temperature limitation has been lowered to 50 degrees Celsius. It has been concluded that 50 degrees Celsius is an appropriate measure for determining whether heat is derived from geothermal reservoirs (heated by the earth's magma) or is derived from heat associated with ground water that is affected by atmospheric temperatures.

Section 1.44C–2(h) of the regulation promulgated November 29, 1980, reads as follows:

(h) *Geothermal energy property.* The term "geothermal energy property" includes equipment (and parts solely related to the functioning of such equipment) necessary to transmit or use energy from a geothermal deposit to heat or cool a dwelling or provide hot water for use within the dwelling. Equipment such as a pipe that serves both a geothermal function (by transmitting hot geothermal water within a dwelling) and a non-geothermal function (by transmitting hot water from a water heater within a dwelling) does not qualify as geothermal property. A geothermal deposit is a geothermal reservoir consisting of natural heat which is from an underground source and is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure), having a temperature exceeding 50 degrees Celsius as measured at the wellhead or, in the case of a natural hot spring (where no well is drilled), at the intake to the distribution system.

It is apparent from the proposed regulations as compared to the final regulations that the only difference in the definition of a geothermal deposit is that in the final regulation, the

temperature requirement of a geothermal deposit is reduced from 60 degrees Celsius to 50 degrees Celsius.

It is not clear whether petitioner in this case is arguing that the definition of a geothermal deposit as contained in the regulations is an unreasonable interpretation of the statute or whether he is arguing that it is arbitrary in his case to make the regulation retroactive. If his argument is that the regulation is unreasonable, we do not agree with his conclusion. This regulation was promulgated pursuant to a specific statutory authority. Such regulations are legislative in nature and should be sustained unless clearly inconsistent with the statute they implement. *Wing v. Commissioner*, 81 T.C. 17, 28 (1983).[3]

Clearly, a requirement of a temperature exceeding 50 degrees Celsius is a reasonable regulation for determining the heat requirement of a geothermal deposit.[4]

We do not agree with petitioner's contention that respondent was arbitrary in applying sec. 1.44C–2(h) of the regulations retroactively either as a general matter or with respect to petitioner.

Section 7805 authorizes the Secretary or his delegate to prescribe regulations for the enforcement of the tax laws. Subsection (b) of that section states:

SEC. 7805(b). RETROACTIVITY OF REGULATIONS OR RULINGS.—The Secretary may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.

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[3] In *Reddy v. Commissioner*, T.C. Memo. 1984–395, we had before us the exact issue with respect to the validity of sec. 1.44C–2(h), Income Tax Regs., as is involved here. In that case, we held this regulation to be a reasonable interpretation of the statute, relying on the legislative nature of the regulation and citing *Wing v. Commissioner*, 81 T.C. 17 (1983); *Olson v. Commissioner*, 81 T.C. 318 (1983). In the *Reddy* case, we pointed out that the temperature limitation was included in the regulation to ensure that only property using geothermal, as opposed to surface sources of energy, would qualify as geothermal property. We concluded that the regulation was clearly consistent with sec. 44C(c)(5)(A) which applies to energy derived from geothermal deposits. Petitioner here argues that we should conclude in this case that the water his heat pump used was geothermal rather than surface since its temperature was consistent throughout the year. There is no evidence in the record to support this conclusion. However, even if this were a fact, it would not cause us to conclude that the water used by petitioner's heat pump met the definition of the regulation which requires a 50-degree Celsius temperature to assure that the energy source is geothermal.

[4] Sec. 613(e)(3), which is referred to for the definition of geothermal deposits, provides in part as follows:

(3) GEOTHERMAL DEPOSIT DEFINED.—For purposes of paragraph (1), the term "geothermal deposit" means a geothermal reservoir consisting of natural heat which is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure). * * *

It is clear from this provision that regulations apply retroactively unless otherwise specified. As was stated in *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957), the language of this section confirms the authority of the Commissioner to make a regulation retroactive. Therefore, except in unusual circumstances, making a regulation retroactive is not an abuse of discretion by the Commissioner. The proposed regulation defining a geothermal deposit as having a temperature exceeding 60 degrees Celsius was published in May 1979, well before petitioner considered the installation of the ground water heat pump in his home. Although we do not doubt petitioner's statement that he interpreted the language contained in IRS Publication 903 to mean that no standards had been specified for determining what constituted a geothermal deposit, we do not agree with his interpretation of this publication. In our view, the standards referred to in the publication were the standards for the equipment and not a definition of a geothermal deposit. For this reason, we need not and do not consider the issue raised by the parties of whether the retroactive application of a regulation that is contrary to IRS publications relied on by a taxpayer might be arbitrary as to that taxpayer. From May 1979, there was public notice in the proposed regulations that a temperature level would be a part of the definition of a geothermal deposit. This is not a case of a regulation which was changed after petitioner had relied upon the prior regulation. Under the circumstances here present, making section 1.44C–2(h) of the regulations retroactive clearly was not an abuse of the Commissioner's authority. *Wendland v. Commissioner*, 79 T.C. 355, 382 (1982), affd. per curiam 739 F.2d 580 (11th Cir. 1984), affd. sub nom. *Redhouse v. Commissioner*, 728 F.2d 1249 (9th Cir. 1984).

Respondent's motion for summary judgment will be granted.

An appropriate order and decision will be entered.

FISHER COMPANIES, INC., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 16064-83. Filed June 24, 1985.

1. In 1974, Fisher Mills, a subsidiary of petitioner, was found guilty on a nolo contendere plea of violating sec. 1 of the Sherman Antitrust Act. No injunction was sought or obtained with respect to this violation. Subsequently American Bakeries and Interstate commenced civil actions against Fisher Mills under sec. 4 of the Clayton Act for treble damages. These civil suits were settled prior to commencement of the trial. ITT believed it had claims against petitioner similar to those asserted by American Bakeries and Interstate, but Fisher Mills settled with ITT prior to commencement of a suit. Petitioner claimed that the entire payment in settlement of the American Bakeries suit was allocable to plaintiff's attorneys' fees and litigation costs. *Held*: (1) On the facts here present, only a portion of the amount paid to American Bakeries is attributable to plaintiff's attorneys' fees and litigation costs and the balance is damages; (2) sec. 162(g), I.R.C. 1954, applies to disallow two-thirds of the damages paid by Fisher Mills for the years of the violation of which it was convicted, but does not limit the deduction of the damages paid for years other than those involved in the criminal conviction because a "related violation" as defined in sec. 1.162-22(c), Income Tax Regs., did not exist due to the absence of an injunction with respect to the violation involved in the criminal proceeding; (3) sec. 162(g) does not limit the deduction of damages paid by petitioner to ITT because the payment was made prior to commencement of a lawsuit against Fisher Mills by ITT and thus was not made "in settlement of any action brought" under sec. 4 of the Clayton Act.

2. Societe, a subsidiary of petitioner, entered into a lease of commercial real estate from another subsidiary of petitioner. Pursuant to the lease agreement, Societe had an obligation to repair the roof on the leased premises. Prior to termination of the lease term, Societe sold its assets, including the leasehold interest, to Golden Grain, a company unrelated to petitioner. Golden Grain assumed Societe's obligation under the lease to repair the roof. The agreed purchase price of Societe's assets to be paid in cash was reduced by the agreed cost of the roof repairs which Societe was obligated to pay. *Held*, the value of Golden Grain's assumption of Societe's leasehold obligation to repair the roof is part of the amount realized by Societe upon the sale of its assets.

George T. Cowan, for the petitioner.
Henry Thomas Schafer, for the respondent.

OPINION

SCOTT, *Judge*: Respondent determined deficiencies in petitioner's income tax for the calendar years 1977 and 1979 in the respective amounts of $119,234 and $222,856. The issues for decision are: (1) Whether the two-thirds disallowance provision in section 162(g)[1] applies to limit the deduction of payments made in 1977 by Fisher Mills, Inc., a subsidiary of petitioner, to American Bakeries Co. in the amount of $432,791.80 and to Interstate Brands Corp. in the amount of $121,500 to settle an action brought under section 4 of the Clayton Act after petitioner's nolo contendere plea was accepted in a prior criminal proceeding involving violation of the Sherman Act where an injunction was neither sought nor obtained and, if such limitation applies, the amount of the disallowance; (2) whether the two-thirds disallowance provision in section 162(g) applies to limit the deduction of a payment made in the amount of $144,039.27 in 1977 by Fisher Mills, Inc., to ITT Continental Baking Co. prior to institution of a civil action under section 4 of the Clayton Act; and (3) whether the purchase price Societe Candy Co. received from the sale of its assets to Golden Grain Macaroni Co. included $500,000 for Golden Grain Macaroni Co.'s assumption of Societe Candy Co.'s leasehold obligation to repair the roof of the leased premises.

All of the facts have been stipulated and are found accordingly.

Petitioner is a corporation duly organized under the laws of the State of Washington. At the time of filing its petition in this case, petitioner maintained its principal place of business in Seattle, Washington. Petitioner filed its corporate Federal income tax returns for taxable years 1977 and 1979 with the Internal Revenue Service Center, Ogden, Utah. Petitioner filed an amended 1977 corporate Federal income tax return on October 15, 1980.

Petitioner filed its 1977 and 1979 Federal income tax returns on a consolidated basis with the following companies for the stated years:

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[1] Unless otherwise stated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years here in issue.

Company	*Years*
Fisher Properties, Inc	1977 and 1979
Trotwood, Inc	1979
Fisher Mills, Inc	1977 and 1979
Murphy Feed Co	1977 and 1979
Napavine Feed Co	1977
Valley Milling Co	1977 and 1979
Sam Wylde Flour Co	1977 and 1979
Fisher Broadcasting, Inc. (formerly Fisher's Blend Station, Inc.)	1977 and 1979
Fisher Services, Inc. (formerly Societe Candy Co.)	1977 and 1979
Imperial Candy Co	1977 and 1979
Technovators, Inc	1977 and 1979
Fisher's CSI, Inc	1977

On August 15, 1972, a grand jury for the United States District Court for the District of Colorado returned a one-count indictment against the following named defendants:

1. Colorado Milling & Elevator Co.
2. Fisher Mills, Inc.
3. California Milling Corp.
4. VWR United Corp. (a.k.a. Univar Corp.)
5. J. Lawson Cook
6. Kenneth R. Fisher
7. Dugald A. MacGregor

At the time of the indictment, Colorado Milling & Elevator Co. was a wholly owned subsidiary of Peavey Co.; Fisher Mills, Inc., was a wholly owned subsidiary of petitioner, Fisher Co.'s, Inc. (formerly known as Fisher Flouring Mills Co.).

The indictment charged conspiracy in restraint of interstate trade and commerce in violation of 15 U.S.C. sec. 1 (1975), commonly known as the Sherman Antitrust Act. The indictment charged that the violation consisted of illegal acts and conduct of the defendants during the period "beginning sometime prior to 1963, the exact date being to the Grand Jurors unknown, and continuing thereafter up to at least 1969."

On March 16, 1973, in the U.S. District Court for the Western District of Washington, Fisher Mills, Inc. (Fisher Mills) was adjudged guilty upon its plea of nolo contendere of violating section 1 of the Sherman Antitrust Act by engaging in a conspiracy during the period August 15, 1967, through

December 31, 1969, to raise, fix, and stabilize the price of bakery flour sold to commercial bakeries located in the western United States and was ordered to pay a fine to the United States in the amount of $10,000. The United States neither sought nor obtained an injunction against Fisher Mills or any of the other defendants.

On March 15, 1974, American Bakeries Co. (American Bakeries) commenced a civil action in the U.S. District Court for the Western District of Washington against the following defendants alleging violations of sections 1 and 2 of the Sherman Antitrust Act (15 U.S.C. secs. 1, 2 (1975)), sections 13 and 13(a) of the Robinson-Patman Act (15 U.S.C. secs. 13, 13(a) (1975)), and seeking damages and injunctive relief pursuant to sections 4 and 16 of the Clayton Act (15 U.S.C. secs. 15, 26 (1975)):

1. Fisher Companies, Inc.
2. Fisher Mills, Inc.
3. VWR United Corp. (a.k.a. Univar Corp.)
4. Colorado Milling & Elevator Co.
5. Great Western United Corp.
6. Peavey Co.
7. California Milling Corp.
8. Conagra-Montana, Inc.
9. Terminal Flour Mills Co.
10. General Foods Corp.
11. Conagra, Inc.

American Bakeries' amended complaint alleged an unlawful conspiracy "commencing at sometime prior to 1955, the exact date being unknown to plaintiff, and continuing up to and including the date of the filling of this amended complaint" (March 15, 1974).

On January 27, 1976, Interstate Brands Corp. (Interstate) commenced a civil action in the U.S. District Court for the Northern District of California against the following defendants alleging violations of sections 1 and 2 of the Sherman Antitrust Act (15 U.S.C. secs. 1, 2 (1975)), and seeking damages and injunctive relief pursuant to section 4 and 16 of the Clayton Act (15 U.S.C. secs. 15, 26 (1975)):

1. Fisher Mills, Inc.
2. VWR United Corp. (a.k.a. Univar Corp.)
3. Colorado Milling & Elevator Co.

4. Peavey Co.
5. California Milling Corp.
6. Conagra, Inc.
7. Conagra-Montana, Inc.

Interstate's complaint alleged an unlawful conspiracy "commencing at sometime prior to 1955, the exact date being unknown to plaintiff, and continuing up to and including the date of the filing of this complaint" (January 27, 1976).

Procedurally, the civil actions commenced by American Bakeries and Interstate were consolidated sub nom. In re West Coast Bakery Flour Antitrust Litigation.

On June 1, 1977, the U.S. District Court entered an order against American Bakeries granting:

(1) Defendant's motion for partial summary judgment to dismiss claims accruing prior to August 15, 1968;

(2) Defendant's motion to strike all claims based on the Robinson-Patman Act prior to 1972; and

(3) Defendant's motion to strike all claims by American Bakeries for damages based on what defendants describe as "prejudgment interest," subject to renewal if and when liability and impact be established.

After this action, settlement discussions continued. In a letter dated June 7, 1977, to the attorney for Fisher Mills and other defendants, the attorney for American Bakeries stated in part:

> You have referred to certain of the Court's rulings last Wednesday to support your settlement offer in behalf of all remaining defendants. First, while the "prejudgment interest" motion was granted, it was granted subject to renewal by American at trial once liability and impact are established.
>
> * * * * * * *
>
> Thirdly, we believe that the Santa Fe rate issue and the issue of fraudulent concealment constitute reversible error and we will be filing motions for reconsideration on both of these issues, as well as alternative requests for certification. The ruling on the Santa Fe issue does not directly affect either the amount or the basis of the damages incurred by American. The freight rate conspiracy, while certainly, we believe, a violation of the Sherman Act, is not nor has it ever been a separate basis for liability but is rather further evidence of the defendants' and co-conspirators' price-fixing activities and the method by which the defendants and co-conspirators effectively excluded competition from the Midwest.
>
> While the fradulent concealment issue has a direct effect on the damages suffered by American, we are convinced that it was wrong for the Court to

grant summary judgment on this issue, that a clear jury question is presented and that the decision will be reversed either by this Court or by the Court of Appeals. If American's motions for reconsideration are denied, and failing a prompt settlement, American will try the case as now framed, and retry the fraudulent concealment and additional damage issues at a second trial.

The American Bakeries litigation was settled on June 28, 1977, the day the trial was to commence, and defendants paid American Bakeries a total of $2,844,996 as follows:

Defendant	*Amount*
Fisher Co., Inc., and subsidiary Fisher Mills, Inc	$432,791.80
VWR United Corp. (a.k.a. Univar Corp.)	432,791.80
Colorado Milling & Elevator Co. (CM & E)	534,256.80
Great Western United Corp	0
Peavey Co	50,000.00
California Milling Corp	219,996.00
Conagra-Montana, Inc., and Conagra, Inc	700,000.00
Terminal Flour Co	50,000.00
General Foods Corp	425,000.00
Unexplained difference	159.60
Total	2,844,996.00

On June 29, 1977, the attorney for American Bakeries addressed a letter to the attorney for Fisher Mills and petitioner. The letter stated in part:

> This is to confirm our understanding that I will notify you on or before August 15, 1977, of the total fees and expenses of the plaintiff in the above action so that the settling defendants in this action can apply a portion of the settlement as a tax deduction.
>
> American Bakeries agrees to this procedure and will cooperate in substantiating an appropriate tax deduction for the settling defendants.

Fisher Mills' settlement with American Bakeries provided that all amounts paid would first reimburse the plaintiff for costs of suit and attorneys' fees and that the remainder of the settlement amount would be attributable to plaintiffs' damages. In a letter dated October 10, 1977, to the attorney for the defendants, Fisher Mills, Inc., Univar Corp., Peavey Co. on behalf of CM & E, Peavey Co., individually, and Terminal Flour Mills, Inc., the lawyer for American Bakeries stated as follows:

> This will confirm our understanding of June 28, 1977, had prior to and as a condition of settlement of the above referred to litigation.

It was agreed that plaintiff, American Bakeries Company, would apply the settlement amounts paid by the defendants, Fisher Mills, Inc., Univar Corporation, and Peavey Company on behalf of CM & E, ($1,400,000), The Peavey Company ($50,000) and Terminal Flour Mills Co. ($50,000) on a prorata basis as follows:

All amounts paid would first reimburse the plaintiff (American Bakeries Company) for costs of suit and attorneys' fees. It was agreed the remainder of the settlement amount, if any, would be attributed to plaintiff's damages.

The plaintiff's (American Bakeries Company) costs of suit and attorneys' fees paid in this action were $1,847,990.50. A settlement was made by plaintiff with defendant California Milling Corporation prior to June 28, 1977. It was agreed between the plaintiff and California Milling Corporation that the entire amount of their settlement ($219,996) would be applied toward plaintiff's costs and attorneys' fees. Consequently, plaintiff American Bakeries Company had paid $1,627,994.50 in costs and attorneys' fees for which it had not been reimbursed by any defendant.

Pursuant to our agreement of settlement, the entire $1,500,000 paid by the defendants, Fisher Mills, Inc., Univar Corporation, and Peavey Company on behalf of CM & E, The Peavey Company, individually, and Terminal Flour Mills, Inc., has been applied by plaintiff American Bakeries Company as reimbursement for its costs of suit and attorneys' fees.

On January 30, 1974, Fisher Mills, California Milling Corp., Colorado Milling & Elevator Co., and VWR United Corp. (Univar Corp.) entered into an agreement that apportioned the cost to be shared by the parties if a judgment was entered against them. On October 10, 1974, Peavey Co. became a party to this agreement and subsequent agreements that would be entered into by the four parties. The parties also entered into a "Memorandum of Agreement Cost Sharing" dated January 30, 1974, which provided for the sharing of certain common expenses incurred in connection with the litigation. On October 10, 1974, the businesses of Peavey Co. and Colorado Milling & Elevator Co. were combined, and Peavey Co. assumed the position of Colorado Milling & Elevator Co. in the litigation.

The parties agreed to share all costs and expenses incurred as follows:

Company	*Percentage*
California Milling Corp	23⅓
Colorado Milling & Elevator Co.[2]	30

[2]The parties agreed in a substitution agreement to substitute Peavey Co. for Colorado Milling & Elevator Co. as a party to the agreement.

Company	Percentage
Fisher Mills, Inc.	23⅓
VWR United Corp.	23⅓

Petitioner and its counsel had full knowledge of all relevant authorities concerning the Federal income tax consequences of antitrust litigation settlement payments, and at the time petitioner entered into the settlement agreement with American Bakeries, petitioner believed the full amounts of such payments would be deductible for Federal income tax purposes.

Pursuant to the settlement agreement, petitioner and Fisher Mills paid $432,791.80 to American Bakeries on or about June 30, 1977. Petitioner included this entire amount in its deductions on its 1977 consolidated Federal income tax return as "Professional Fees and Settlements—$1,313,252."

On July 1, 1977, on the motion of American Bakeries, the U.S. District Court for the Western District of Washington dismissed with prejudice and without costs the American Bakeries' suit against defendant Fisher Co.'s, Inc., on the ground that no evidence had been produced which would in any way substantiate the allegations of American Bakeries as to the alleged activities of Fisher Co.'s, Inc.

On July 1, 1977, pursuant to a joint Stipulation and Order for Dismissal, American Bakeries dismissed with prejudice its complaints against each of the following defendants with each party to bear its own costs:

(a) Fisher Mills, Inc.
(b) Colorado Milling & Elevator Co.
(c) Univar Corp.
(d) Terminal Flour Mills Co.
(e) Great Western United Corp.

Each of the aforementioned defendants also dismissed with prejudice their counterclaims against American Bakeries.

The release document executed on July 1, 1977, between American Bakeries and Fisher Co.'s Inc., and American Bakeries and Fisher Mills, respectively, each specifically provided as follows:

each of the undersigned hereby releases and forever discharges each other (the "Releasee") * * * from any and all manner of action or actions, cause or causes of action, in law or in equity, including claims under the federal or

state antitrust laws * * *, of any nature whatsoever known or unknown, fixed or contingent (hereinafter called "Claims"), which the respective undersigned now has or may hereafter have against the Releasee by reason of any matter, cause, or thing whatsoever from the beginning of time to the date hereof including, without limiting the generality of the foregoing, any Claims arising out of, based upon, or relating to that certain suit now pending in the Federal District Court for the Western District of Washington entitled *American Bakeries Company v. Fisher Companies, Inc.*, No. 185–732C2, including any cases filed by American Bakeries in any other Districts consolidated with this action, as well as any matters, causes or things whatsoever that were or have been, or could in any way have been, alleged in the respective pleadings filed in said suit (but excepting any contractual rights either party has as to the other under any existing contract).

On March 8, 1977, the defendants, Fisher Mills, Inc., et al., in the Interstate litigation filed a motion for partial summary judgment in the U.S. District Court for the Western District of Washington. On May 18, 1977, the District Court entered an order granting defendants' motion for partial summary judgment and dismissing damage claims which accrued prior to January 27, 1972.

The Interstate litigation was settled on December 30, 1977, when defendants paid a total of $500,000 to Interstate as follows:

Defendant	*Amount*
Fisher Mills, Inc	$121,500.00
VWR United Corp	121,500.00
Colorado Milling & Elevator Co. and Peavey Co	149,999.85
California Milling Corp	57,000.15
Conagra, Inc. and Conagra-Montana, Inc	50,000.00
Total	500,000.00

Pursuant to the settlement agreement, Fisher Mills paid $121,500 to Interstate on or about December 31, 1977, and this entire amount was included in petitioner's deductions on its 1977 consolidated Federal income tax return as "Professional Fees and Settlements—$1,313,252.00." The settlement agreement provided that all payments by the defendants first be applied to reimbursement of Interstate's attorneys' fees and costs of suit, with the remainder, if any, to be attributed to plaintiff's damages. In an undated letter to the attorney for Fisher Mills and the other defendants, the attorney for Interstate stated in part as follows:

This will confirm that, as a condition and term of the settlement, we agreed as follows:

1. Interstate Brands Corporation shall apply the $500,000 payment made by Defendants in full settlement of the above-entitled action as follows: The proceeds shall first reimburse Plaintiff (Interstate Brands Corporation) for costs of suit and attorneys' fees, and the remainder of the settlement proceeds, if any, shall be attributed to Plaintiff's claims for damages for the period subsequent to January 27, 1972, as established by the Order of the Honorable George H. Boldt dated May 18, 1977.

A letter dated December 30, 1977, addressed to the attorney for Interstate by the attorney for Fisher Mills and the other defendants stated in part as follows:

As I indicated to you in our earlier telephone conversation, the Defendants in the Interstate case are prepared to pay your client $500,000 cash and dismiss with prejudice their counterclaim in exchange for:

* * * * * * *

c. Confirmation from you that Interstate Brands Corporation will apply the $500,000 payment in accordance with the letter herewith enclosed and provide the requested tax information; * * *

Petitioner and its counsel had full knowledge of all relevant authorities concerning the Federal income tax consequences of antitrust litigation settlement payments, and at the time petitioner entered into the settlement agreements with Interstate, petitioner believed the full amounts of such payments would be deductible for Federal income tax purposes.

In a letter dated January 9, 1978, addressed to the attorney for Fisher Mills and other defendants, the attorney for Interstate stated in part: "Upon receipt of the settlement monies I shall as promptly as possible arrange for all the documents to be returned and shall provide you with the required tax information."

On January 30, 1978, Fisher Mills was informed that Interstate incurred and paid $180,000 for litigation costs and attorneys' fees with respect to the civil litigation brought against petitioner and other defendants.

The release document executed on January 6, 1978, between Interstate and Fisher Mills specifically provided as follows:

each of the undersigned hereby releases and forever discharges each other (the "Releasee") * * * from any and all manner of action or actions, cause or causes of action, in law or in equity, including claims under the federal or

state antitrust laws * * * of any nature whatsoever known or unknown, fixed or contingent (hereinafter called "Claims"), which the respective undersigned now has or may hereafter have against the Releasee by reason of any matter, cause or thing whatsoever from the beginning of time to the date hereof including, without limiting the generality of the foregoing, any Claims arising out of, based upon, or relating to that certain suit consolidated in *In Re West Coast Bakery Flour Antitrust Litigation* (M.D.L. Docket No. 146) in the Federal District Court for the Western District of Washington, entitled *Interstate Brands Corporation v. Fisher Mills, Inc., et al.*, C76 189SAW (N.D. Cal.), as well as any matters, causes or things whatsoever that were or have been, or could in any way have been, alleged in the respective pleadings filed in said suit (but excepting any contractual rights either party has as to the other under any existing contract).

ITT Continental Baking Co. (ITT), a major national baker, believed it had claims against Fisher Mills and other defendants similar to the claims asserted in the case brought by American Bakeries against Fisher Mills.

On March 4, 1974, an agreement was reached between ITT and California Milling Corp., Colorado Milling & Elevator Co., Fisher Co.'s, VWR United Corp., and Fisher Mills (the millers). The parties agreed to settle without litigation, claims which ITT believed it could assert against such millers, and defenses, counterclaims, and offsets which such millers would assert against ITT. The ITT agreement provided that such millers would pay to ITT 35.4 percent of the single damage liability to American Bakeries established by final judgment, or 35.4 percent of any settlement payment to American Bakeries before judgment. ITT did not commence an action or suit against the millers.

Pursuant to the ITT agreement, the millers paid $573,478.76 (before technical adjustments) to ITT in settlement as follows:

Defendant	*Amount*
Colorado Milling & Elevator Co	$191,157.67
Fisher Mills, Inc	154,839.27
Univar Corp	154,839.27
California Milling Corp	72,642.55
Total	573,478.76

The settlement payments made by the millers (before adjustments) were 35.4 percent of the amount of their settlement with American Bakeries. After a number of adjustments, the amount of $144,039.27 was paid in 1977 by Fisher Mills to ITT. This amount was included in petitioner's deductions on its

1977 Federal income tax return as "Professional Fees and Settlements—$1,313,252."

The relevant terms of the ITT agreement provided as follows:

1. *Recitations.*

The Millers are involved in a case brought by American Bakeries Company (herein "American") in the Federal Court in the Western District of Washington for the recovery of civil damages for alleged violation of the Sherman Act by the Millers. Continental is a major national baker and believes it could assert similar claims against the Millers and has in fact taken steps toward the commencement of such litigation. The Millers believe that they have valid defenses, counterclaims and offsets against any claims Continental might assert.

All parties deny that they have violated the antitrust laws or engaged in any other wrongdoing. It is recognized, however, that there are uncertainties and injustices in the trial of antitrust matters including the possibility of the exaction of treble damages (the existence of which a jury may not be aware), attorneys fees, costs and interest.

It is also recognized that any such litigation involving the parties would be complex, expensive and harmful to all parties. This Agreement is entered into to avoid such litigation by effecting a negotiated, amicable settlement of the claims and counterclaims which Continental and the Millers may have against each other.

2. *Releases.*

Continental and Millers hereby release each other from all claims for any alleged violation of federal or state antitrust laws based upon any act or failure to act which occurred prior to the date of this agreement, whether known or unknown. These releases are intended solely for the benefit of the parties to this agreement, and no party intends the releases contained herein to apply to, or run to the benefit of, any other person, firm, or corporation.

Continental will not, nor will anyone on its behalf nor any assignee, commence any action or suit * * * for any alleged violation(s) of federal or state antitrust laws arising out of the violations alleged in the action entitled *United States v. Colorado Milling & Elevator Company, et al.*, Crim. No. 72 CR 233 (D. Colo. 1972), which, upon transfer to the Western District of Washington, became No. 287–72D2 (W.D. Wash.) (hereinafter "*U.S. v. CM & E*").

3. *Settlement Payment.*

This agreement provides for a settlement payment to Continental by the Millers, jointly and severally, in the event of an adverse final judgment based upon the alleged violation(s) of the Sherman Act in the American case or a settlement of American's Sherman Act claims.

(a) *Amount.*

The amount of the settlement payment to be made to Continental shall be:

(i) in the event of such final judgment in the American case, 35.4 percent of the single damage liability to American established by the final judgment; or

(ii) in the event of settlement with American before the verdict of the jury or decision of the Judge, 35.4 percent of the amount of the settlement with American.

If a settlement of the American case is consummated after the verdict or decision has been announced in the trial court, the amount of the settlement payment to be made to Continental shall be 35.4 percent of the lesser of:

(i) the single damage liability set forth in the verdict or decision; or

(ii) the amount of the settlement with American.

* * * * * * *

(c) *Definitions.*

(1) "Final judgment" means a judgment in favor of American entered by the trial court, after trial on the issues of liability and damages which becomes final either after completion of all available proceedings for direct review thereof, or after expiration of the time to obtain initial or further direct review.

(2) "The American case" means the case pending in the United States District Court for the Western District of Washington No. 185–73C2, in which American Bakeries Company is plaintiff and Fisher Companies, Inc., et al., are defendants.

(3) "Single damage liability" means the amount of compensatory damages, only, awarded by the court or a jury as the case may be in the American case and does not include any amount based upon interest, costs, attorneys' fees or the trebling of damages.

(4) "The amount of the settlement with American" means all amounts paid by any Miller to American, no matter in what form nor how described, which are intended to or which in fact do cause dismissal or settlement of the Sherman Act claims in the American case. * * *

On January 1, 1973, Fisher Properties, Inc., as lessor, and Societe Candy Co. (Societe), as lessee, both subsidiaries of petitioner, entered into a 20-year lease of improved commercial real estate in King County, Washington. Societe conducted its business on the premises and was obligated under the lease to pay annual rent of $160,412 for each year during the original lease term which extended from January 1, 1973, to January 1, 1993. The lease provided as follows:

Maintenance and Repairs. Lessor shall keep the roof, exterior walls and foundation of the leased premises in as good a state of repair as they presently are and shall accomplish repairs to such portions of the leased premises as may be needed promptly after receipt of written notice from Lessee. Lessor shall not be called upon to make any improvements or other repairs of any kind to or upon the premises. Should Lessor fail to make such repairs within a reasonable time, Lessee may make such repairs and deduct the cost thereof from the rental amount(s) next due. * * * Lessee shall be

responsible for all other repairs and/or maintenance on or about the leased premises * * *

On July 26, 1979, Societe and Fisher Properties, Inc., entered into an amendment of the original lease because Societe wanted to sell certain assets that existed on the property and the purchaser of the assets wanted to assume the lease, provided certain amendments were made. The amendment increased the monthly lease payments due, imposed upon the lessee the obligation to repair the roof by June 30, 1980, and granted to the lessee an option to purchase the property at any time during the period commencing January 1, 1980, and extending through December 31, 1981, at a price of $3,390,000. The base rent to be paid under the amended lease was $30,400 per month or $364,800 per year during the period beginning August 1, 1979, through December 31, 1984, and during the period from January 1, 1985, to the last day of the lease term, the monthly rent was the greater of $30,400 or the annual fair rental value of the property as determined by three real estate appraisers on December 1, 1984.

Pursuant to the July 26, 1979, lease amendment, Societe became obligated to repair the roof of the leased premises and obtained an option to purchase the improved real estate:

20. *Roof Repair.* Lessee acknowledges that there presently are deficiencies in the roof of the leased premises, and Lessee accepts the leased premises with full knowledge that significant corrective action must be taken in order to put the roof in suitable condition. Lessee agrees to undertake and perform such repairs to the roof as are necessary to place it in a good condition, appropriate to the building and commensurate with its age, such repairs to be completed prior to June 30, 1980. Such repair work may be performed by Lessee as and when it can do so, having in mind the continued efficient operation of the plant, and may be accomplished in the manner and method of Lessee's choice. Lessee accepts and assumes full responsibility for the condition of the roof and will indemnify and hold Lessor harmless from all loss, damage, liability, costs and expenses resulting from or arising out of the condition of the roof.

21. *Option to Purchase Real Property.* Lessor hereby gives and grants to Lessee the exclusive option to purchase the Real Property, together with all the buildings and all other improvements thereon. This option is given on the following terms and conditions:

21.1 The option period shall be January 1, 1980, through December 31, 1981 (hereafter the "Option Period"). Lessee may exercise the option by giving written notice thereof to Lessor at any time during the Option Period. Lessee's option rights shall expire on December 31, 1931.

21.2 The purchase price of the Real Property shall be Three Million Three Hundred Ninety Thousand Dollars ($3,390,000) (hereinafter the "Option Price"). The Option Price shall be paid in full by certified or cashier's check on the closing date.

On July 27, 1979, Societe sold Golden Grain Macaroni Co. (Golden Grain) all of the operating assets of Societe as follows:

1. *Assets to be Sold.* Seller hereby sells to Buyer and Buyer hereby purchases from Seller, the following assets (hereinafter collectively called "the Assets"):

(a) All of the Seller's inventory of raw materials, finished manufactured goods, finished resale goods, finished boxed chocolates, packaging, wrapping, ingredients, chocolate candy, non-chocolate candy, and work in process (the "Inventory");

(b) All of the machinery and equipment, office furniture, and other equipment owned by Societe and used in connection with its candy manufacturing and distribution business, all as more particularly described in Schedule A attached hereto;

(c) All of the Seller's leasehold improvements situated on its premises at 11959 Northrup Way, Bellevue, Washington;

(d) All of those prepaid expenses identified on Schedule B attached hereto;

(e) All of Seller's interest under that certain lease dated January 1, 1973, in which FISHER PROPERTIES, INC., is the Lessor affecting the Seller's premises at 11959 Northrup Way, Bellevue, Washington, as amended July 26, 1979 ("the Plant Lease");

(f) The trademarks "Societe" and "Imperial";

(g) All fuel oil in tanks owned by Seller;

(h) All right, title, and interest of Seller in and to that certain Microdata Minicomputer Reality System under Master Equipment Lease dated May 12, 1975 from Citicorp Leasing, Inc., and, subject to the provisions of Paragraph 25 hereof, the option to purchase said system at seven percent (7%) of its original installed cost at the termination of the lease term.

The purchase price for these assets was $2,004,751 against which Societe granted a $500,000 offset to the purchase price for certain deficiencies which both parties acknowledged existed in the roof of the premises subject to the lease and the assumption by Golden Grain of Societe's obligation under its lease to repair the roof. Golden Grain paid $1,504,751 to Societe, reflecting the purchase price less the $500,000 offset. The agreement provided as follows:

2. *Purchase Price.* The purchase price of the Assets shall be the sum of:

(a) $1,422,210.40 for the Inventory, such amount to be adjusted after the Date of Closing as provided in Paragraph 5.

(b) The total amount of the prepaid expenses listed on Schedule B, such amount to be adjusted after the Date of Closing as provided in Paragraph 23.

(c) The cost to the Seller of the fuel oil in tanks at the date of closing; and

(d) Three Hundred Eighty-nine Thousand and Fifty-nine Dollars ($389,059.00), such amount allocated among the Assets as follows: (i) $284,485 to Fixed Assets as described in Schedule A; (ii) $100,000 to Leasehold Improvements; and (iii) $4,574 to Trademarks of Seller.

Provided, that the total amount payable shall be adjusted as provided in Paragraphs 5, 6, 11, and 23 hereof. The purchase price of the Assets, less the amount of the adjustments provided in Paragraphs 6 and 11, shall be paid in cash at the closing.

* * * * * * *

6. *Adjustment of Purchase Price.* The parties agree that there exist certain deficiencies in the roof of the building on the premises subject to the Plant Lease, that *Buyer has assumed full responsibility for the roof, and that Buyer will assume the responsibility of Seller to repair the roof under the terms of the Plant Lease.* In consideration thereof, Seller agrees to pay Buyer the amount of Five Hundred Thousand Dollars ($500,000.00), which amount may be offset by the amount payable by Buyer to Seller. Buyer shall indemnify and hold Seller harmless against and from any liabilities, costs, or expense arising out of any damage to property or injury to persons arising out of any defect or alleged defect in such roof. [Emphasis added.]

Societe assigned the plant lease to Golden Grain, and Golden Grain relieved Societe from all obligations under the lease as follows:

4. *Assignment of Plant Lease.* Seller shall assign the Plant Lease to Buyer and Buyer shall assume and hold harmless Seller against and from all obligations of the Seller thereunder as of the closing date. Seller shall not amend or agree to amend the Plant Lease without the prior written consent of Buyer.

On its 1979 Federal income tax return, petitioner reported an ordinary loss in the amount of $2,458,126 on the sale of the operating assets of Societe, computed as follows:

Total cost or other basis	$6,362,986
Less: depreciation allowed	(2,400,109)
Adjusted basis	3,962,877
Proceeds received	1,504,751
Net loss to line 10	2,458,126

Golden Grain spent the following amounts on roof repairs in 1979 and 1980:

Expenditure	*Date*
$37,320.92	Oct. 3, 1979
12,452.95	Dec. 3, 1979
22,674.22	Feb. 19, 1980
801.16	Mar. 10, 1980
13,694.28	Apr. 1, 1980
124,134.41	July 1980
193.80	Sept. 1980
119,765.85	Oct. 1980
168,962.41	Oct. 1980
500,000.00	

In his notice of deficiency issued to petitioner, respondent disallowed petitioner's deduction in 1977 for professional fees and settlements to the extent of $248,403 with the explanation that "no deduction is allowable for two-thirds of any amount paid with respect to judgments or settlement on account of violations of federal anti-trust laws." Respondent computed the $248,403 disallowed as follows:

	American Bakeries Co.	*ITT Continental Baking Co., Inc.*	*Interstate Brands Corp.*	*Total Adjustments*
(1) Amount paid by all parties	$2,844,996	[3]$114,039	$500,000	
Less:				
(2) Litigation expense	1,853,669	0	180,000	
(3) Balance	991,327	114,039	320,000	
(4) Amount paid by Fisher in U.S.	432,792	[4]114,029	121,500	
(5) Line (4) ÷ (1)	.152,124	[5].100	.24,300	
(6) Line (5) × (3)	150,805	[4]144,029	77,760	
(7) Line (6) × two-thirds	[6]100,537	96,026	[6]51,840	$248,403

In the notice of deficiency, respondent also determined that the amount received from the sale of certain operating assets by Fisher Services, Inc. (formerly Societe Candy Co.) was $2,004,751 rather than the $1,504,751 reported on petitioner's 1979 Federal income tax returns. Therefore, respondent increased petitioner's income by the amount of $500,000.

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[3]According to the stipulation of facts, the total amount paid by all parties pursuant to the ITT agreement was $573,478.76, and the amount paid by petitioner after technical adjustments was $144,039.27.

[4]In the stipulation of facts, the parties agree that these figures should be $144,039.

[5]This obviously was intended to be 1.00.

[6]Through this computation respondent effectively apportioned $281,987 of the litigation expenses of American Bakeries to Fisher Mills ($432,792 – $281,987 = $150,805) and $43,740 of the Interstate litigation expenses to Fisher Mills ($121,500 – $43,740 = $77,760).

The first issue for decision is whether the two-thirds disallowance provision in section 162(g) applies to limit the deduction of payments made by Fisher Mills to settle the actions brought by American Bakeries and Interstate under section 4 of the Clayton Act after Fisher Mills' nolo contendere plea was accepted in a prior criminal proceeding where an injunction was not obtained. The determination of this issue depends on whether the deduction of any part of the payment is to be disallowed under the provisions of section 162(g) since prior to the enactment of that section, amounts paid as a result of litigation under section 4 of the Clayton Act in settlement of such litigation had been considered by respondent to be deductible. Also, in *Commissioner v. Tellier*, 383 U.S. 687 (1966), the Supreme Court had limited the circumstances in which otherwise business expenses might be considered as nondeductible because such deduction would violate public policy.

In *Commissioner v. Tellier, supra*, the Supreme Court held legal fees expended in an unsuccessful defense of a business-related criminal prosecution to be deductible. The Court stated, at pages 694–695, that disallowance is justified "only where the allowance of a deduction would 'frustrate sharply defined national or state policies proscribing particular types of conduct.'" The Court added that the "policies frustrated must be national or state policies evidenced by some *governmental* declaration of them." 383 U.S. at 694.

In the Tax Reform Act of 1969,[7] Pub. L. 91–172 (Dec. 30, 1969), the public policy doctrine as to deduction of payments in connection with antitrust law violation was clarified by the addition to the Internal Revenue Code of section 162(g) which provides:

> SEC. 162(g). TREBLE DAMAGE PAYMENTS UNDER THE ANTITRUST LAWS.—If in a criminal proceeding a taxpayer is convicted of a violation of the antitrust laws, or his plea of guilty or nolo contendere to an indictment or information charging such a violation is entered or accepted in such a proceeding, no deduction shall be allowed under subsection (a) for two-thirds of any amount paid or incurred—

[7] For detailed discussion of the legislative history of this provision of the Tax Reform Act of 1969, see Wilberding, "New Tax Consideration Injected Into Antitrust Treble Damage Proceedings," 19 Kan. L. Rev. 441 (1971); Boland, "Income Tax Treatment of Antitrust Damages," 22 Tax L. Rev. 47 (1966).

(1) on any judgment for damages entered against the taxpayer under section 4 of the Act entitled "An Act to supplement existing laws against unlawful restraints and monopolies, and for other purposes", approved October 15, 1914 (commonly known as the Clayton Act), on account of such violation or any related violation of the antitrust laws which occurred prior to the date of the final judgment of such conviction, or

(2) in settlement of any action brought under such section 4 on account of such violation or related violation.

The preceding sentence shall not apply with respect to any conviction or plea before January 1, 1970, or to any conviction or plea on or after such date in a new trial following an appeal of a conviction before such date.

Although the Code does not define "related violation," section 1.162–22(c), Income Tax Regs., provides:

(c) *Related violation.* For purposes of this section, a violation of the Federal antitrust laws is related to a subsequent violation if (1) with respect to the subsequent violation the United States obtains both a judgment in a criminal proceeding and an injunction against the taxpayer, and (2) the taxpayer's actions which constituted the prior violation would have contravened such injunction if such injunction were applicable at the time of the prior violation.

Section 1.162–22(a), Income Tax Regs., provides that the two-thirds disallowance provision does not apply to "amounts attributable to the plaintiff's costs of suit and attorney's fees, to the extent that such costs or fees have actually been paid."

Petitioner contends that the entire payment made by Fisher Mills to American Bakeries was attributable to American Bakeries' costs of suit and attorneys' fees and therefore deductible under the provisions of respondent's regulation. Petitioner bases this contention on the statement contained in the letter from American Bakeries' attorney concerning the settlement agreement that $1,500,000 paid by Fisher Mills and four other named defendants would be allocated by American Bakeries first to the reimbursement of its attorneys' fees and litigation costs, with the remainder, if any, to be attributable to damages. Petitioner argues that the agreement of American Bakeries to make this attribution was part of the settlement and since American Bakeries' attorneys' fees and litigation costs exceeded $1,500,000, Fisher Mills paid no amount to American Bakeries for damages as defined in respondent's regulation issued under section 162(g).

Respondent contends that the payments Fisher Mills made to American Bakeries were characterized as reimbursement of the plaintiff's cost of litigation and attorneys' fees solely to enable petitioner to obtain a tax deduction. Respondent contends that part of the payment was damages nondeductible to the extent provided in section 162(g) and that petitioner's characterization of the damages as an "expense reimbursement" was made in an effort to obtain a tax deduction for an amount which in reality was damages. Respondent points out that the actual amount of the payment to be made to American Bakeries was determined long before Fisher Mills' attorney learned of the monetary amount of the fees and costs incurred by American Bakeries.

Respondent applied a proportional allocation to Fisher Mills' payments in order to determine the portion of each payment which should realistically be considered a deductible expense. Respondent computed that petitioner was entitled to deduct $281,987 of its reimbursement to American Bakeries and $43,740 to Interstate as reimbursement of each company's attorneys' fees and litigation costs.[6]

Respondent contends that two-thirds of the remaining portions of the payment by Fisher Mills to American Bakeries ($100,537) and $51,840 of the amount paid to Interstate are not deductible pursuant to section 162(g). In support of his position, respondent suggests that we ignore the definition of "related violation" found in the regulations and instead apply his proferred "economic objective" test. According to respondent, the term "related violation" means a violation committed to accomplish the same ultimate economic objective as the objective for the violation of which a taxpayer was convicted. In respondent's view, the "economic objective" test should be used in the context of substantial factual identity (other than dates) of both the criminal antitrust violation and the antitrust violation resulting in the civil suit for treble damages. Even though an injunction was not obtained in the instant case, respondent argues that the civil suit was based on a

[6] Petitioner does not contend that its entire payment to Interstate was a reimbursement of the plaintiff's attorneys' fees and litigation costs. Although not specifically so stated, petitioner apparently accepts respondent's allocation of the amount of Fisher Mills' payment to Interstate allocable to attorneys' fees and litigation costs. Respondent questions, however, petitioner's allocation of the payment in excess of attorneys' fees to the period after Jan. 27, 1972.

"related violation" to the violation of which Fisher Mills was convicted for purposes of section 162(g) because the same economic objective induced the acts for which Fisher Mills was convicted and the acts that formed the basis of the civil suit.

Petitioner[9] takes the position that the limitations imposed by section 162(g) on the deductibility of damages paid in an antitrust suit do not apply in the instant case because the payments made by Fisher Mills to American Bakeries were not attributable to damages resulting from a violation of antitrust laws for which Fisher Mills was convicted or a "related violation" pursuant to the definition of "related violation" found in sec. 1.162–22(c), Income Tax Regs. Petitioner argues that the payments made by Fisher Mills to American Bakeries in the amount of $432,791.80 and to Interstate in the amount of $121,500 are fully deductible. In the case of the American Bakeries payment, petitioner contends that the total amount represents deductible attorneys' fees and litigation costs. In the alternative, petitioner argues that the American Bakeries payment was not paid with respect to a violation of the antitrust laws or a related violation. Petitioner contends that to the extent that the payment to Interstate does not consist of the plaintiff's attorneys' fees and costs, it also was not made with respect to a violation of antitrust laws or a related violation.

We are unconvinced that the entire amount paid by Fisher Mills to American Bakeries represented amounts paid for litigation costs and attorneys' fees as claimed by petitioner. It is petitioner's burden to prove the part of the settlement payment that is allocable to attorneys' fees and litigation costs. *Bresler v. Commissioner*, 65 T.C. 182, 188 (1975); *Estate of Carter v. Commissioner*, 35 T.C. 326, 333 (1960).

To sustain this burden, petitioner relies solely upon the statements in a letter from American Bakeries' attorney that payment will be attributed first to the reimbursement of attorneys' fees and litigation costs, and the remainder, if any, is to be attributed to damages.

In letters dated June 29, 1977, and January 9, 1978, to Fisher Mills' attorneys from the attorneys for American

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[9]Fisher Mills is a subsidiary of Fisher Co.'s, Inc., which is the petitioner in this case. In the interest of simplicity, we sometimes refer to Fisher Mills as the petitioner in discussing the arguments of the parties and our conclusion.

Bakeries, the statement is made that American Bakeries would attribute the amounts paid to it by Fisher Mills and four other defendants to attorneys' fees and litigation costs and would assist these companies in determining the amount deductible for their income tax computation. It is apparent to us that these letters were written solely for the purpose of enabling Fisher Mills and the other four defendants to claim a deduction for the amounts paid to American Bakeries in computing their taxable income. There is nothing in this record to show that the other defendants settling with American Bakeries did not consider their settlements to be in part allocable to American Bakeries' costs of litigation and attorneys' fees. So far as this record shows, Fisher Mills and the four other defendants whose payments American Bakeries agreed to attribute to litigation costs and attorneys' fees had no understanding with the other defendants that their payment would be allocated to such costs of American Bakeries to the exclusion of such other defendants having a proportionate part of such allocation. Petitioner, on this record, has totally failed to show error in respondent's allocation of the payment made by Fisher Mills to American Bakeries to litigation costs and attorneys' fees.

We therefore adopt the apportionment used by respondent to allocate the payments petitioner made between damages and attorneys' fees.

In order for the two-thirds disallowance provided in section 162(g) to apply to the portion of the payments allocable to damages, the statute and respondent's regulations require that the following elements exist:

(1) There must be a prior criminal proceeding in which the taxpayer was convicted of violating the Federal antitrust laws, or in which he entered his plea of guilty or nolo contendere to an indictment charging violation of the Federal antitrust laws. Sec. 162(g).

(2) There must also be a civil action brought under section 4 of the Clayton Act which provides that a plaintiff who prevails in an antitrust suit may also recover treble damages.[10]

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[10] 15 U.S.C. sec. 15 (1975). Sec. 4 of the Clayton Act provides in pertinent part: "Any person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws may sue therefor * * * without respect to the amount in controversy, and shall recover threefold the damages by him sustained."

(3) The treble damage payments must be made to satisfy either a judgment rendered in the action brought under section 4 of the Clayton Act or must be in settlement of the action brought under section 4 of the Clayton Act on account of the criminal violation or a "related violation." Sec. 162(g)(1) and (2).[11]

(4) If the damages are paid in settlement of any action brought under section 4, Court proceedings must have been instituted by the plaintiff's filing his complaint for treble damages. Sec. 162(g)(2).

(5) The damage payments must not be attributable to reimbursement of litigation costs or attorneys' fees which are fully deductible. Sec. 1.162–22(a), Income Tax Regs.

In this case, neither party contends that the settlement did not result from a civil suit based on acts similar to the acts for which Fisher Mills was convicted of antitrust violations.[12] In fact, the record shows that it was. Petitioner, however, claims that the settlement, at least as to Interstate and either in whole or in part as to American Bakeries, was not for the years of its conviction and that there was no related violation under respondent's regulations.[13] Petitioner contends that all

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[11]Criminal antitrust violations are subject to a 5-year statute of limitation period under 18 U.S.C. sec. 3282 (1979), while civil damage actions brought under sec. 4 of the Clayton Act are subject to a 4-year statute of limitation under 15 U.S.C. sec. 15b (1975). However, the civil statute of limitations may be tolled by fraudulent concealment of a conspiracy. As heretofore pointed out, sec. 1.162–22(c), Income Tax Regs., defines a "related violation" as requiring the United States to have obtained both a judgment in the criminal proceeding and an injunction against the taxpayer. Sec. 1.162–22(f), example (2), Income Tax Regs., considers the case where the Government has obtained an injunction and a criminal judgment against a taxpayer for activities occurring between 1965 and 1970, while the civil damage action was based on a conspiracy occurring during 1963, "a year barred by the applicable criminal statute of limitations," but for which the pleadings in the civil action "alleged that the civil statute of limitations had been tolled by the defendants' fraudulent concealment of their conspiracy."

[12]See example (3) of sec. 1.162–22(f), Income Tax Regs., which provides:

Example (3). Assume the same facts as in example (1) [a conviction of antitrust violations with respect to electric transformers and an injunction with respect to price fixing of transformers] except that Z Co.'s claim for treble damages was based on a conspiracy to fix and maintain prices with respect to electrical insulators for high-tension power poles. Since the civil action was not based on the same violation of the Federal antitrust laws as the criminal action, or on a related violation (a violation which would have contravened the injunction if it were applicable), X Co. and Y Co. are not precluded by section 162(g) from deducting as a trade or business expense the entire $85,000 paid by each in settlement of the civil action.

[13]It is not clear from petitioner's argument that it does not concede that part of the payment with respect to American Bakeries was on account of the violation for which it was convicted if we hold as we have that the entire payment it made to American Bakeries was not in reimbursement of American Bakeries' attorneys' fees and litigation costs. Petitioner does contend that no part of the payment to Interstate was on account of such violation, since it claims that the entire payment was for the period subsequent to January 1972. Fisher Mills' criminal conviction was for the period from Aug. 15, 1967, to Dec. 31, 1969.

or a portion of its payments were for years other than the years for which it was convicted of a criminal act and that this portion of the payment was not with respect to a "related violation" because the United States did not obtain an injunction against Fisher Mills or any of the other indicted defendants on March 16, 1973, when Fisher Mills was convicted on its plea of nolo contendere of violating the Sherman Act during the period from August 15, 1967, through 1969.[14]

In the report of the Senate Finance Committee, it is stated that the disallowance is limited to the so-called "hard-core" cases where the defendant's conduct is so flagrant as to warrant criminal prosecution and where the defendant's intent has been clearly proved. The Senate Finance Committee report recommending adoption of the proposed legislation stated:

> The deduction is denied * * * only where there has been a criminal conviction (or a plea of guilty or nolo contendere) in a related case. This means that the deduction is to be denied only in the case of "hard-core violations" where intent has been clearly proved in a criminal proceeding. The denial of the deduction is limited to two-thirds of the amount paid or incurred since this represents the "penal" portion of the payment. The remaining one-third is to continue to be deductible on the grounds that it represents a restoration of the amount already owing to the other party. [S. Rept. 91-552 (1969), 1969-3 C.B. 597.]

Respondent's regulation disallowing a deduction of two-thirds of any treble damages for years other than the years for which the taxpayer is criminally convicted only if, in addition to accepting petitioner's nolo contendere plea, the Government also obtains an injunction against the antitrust violator, appears to be in accordance with the intent of Congress as expressed in the report of the Senate Finance Committee. The interpretation of the statute by the regulation, disallowing treble damage payments as "related" to a prior criminal violation only if a judgment and an injunction were entered in the prior proceedings, appears to implement the intent of the

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[14] Sec. 1.162-22(c), Income Tax Regs., defines "related violation" as follows:

> (c) *Related violation.* For purposes of this section, a violation of the Federal antitrust laws is related to a subsequent violation if (1) with respect to the subsequent violation the United States obtains both a judgment in a criminal proceeding and an injunction against the taxpayer, and (2) the taxpayer's actions which constituted the prior violation would have contravened such injunction if such injunction were applicable at the time of the prior violation.

statute which was to provide for a disallowance only in "hard-core" cases.

In our view, the injunction requirement in section 1.162–22(c) of the regulations reinforces the intent of Congress in enacting section 162(g) which was to deny a two-thirds deduction for treble damage payments only in the most flagrant violations of the Federal antitrust laws where the Government has proved the defendant's guilt beyond a doubt. In any event, respondent should be bound by his own regulations in circumstances such as those here present.[15]

We hold that the two-thirds disallowance provision in section 162(g) does not apply to the payments petitioner made to American Bakeries and Interstate for years other than the years involved in the criminal conviction which covered the period from August 15, 1967, to December 31, 1969. Section 162(g) does apply to the years for which Fisher Mills was criminally convicted since it specifically applies to a conviction on a nolo contendere plea.

The record shows that the period covered in Fisher Mills' conviction of an antitrust violation was from August 15, 1967, to December 31, 1969, or 28.5 months. Petitioner argues that, because of the decision of the District Court granting Fisher Mills' motion to dismiss the claims of Interstate for the period prior to January 27, 1972, and Interstate's agreement to attribute the payments made to it by Fisher Mills, first to the costs of the suit and attorneys' fees, and the remainder to the claim for damages for the period subsequent to January 27, 1972, no portion of the payment to Interstate is allocable to the period of the violation. For the same reason we stated in rejecting petitioner's claim that its entire payment to American Bakeries should be allocated to American Bakeries' costs of suit and attorneys' fees, we conclude that petitioner's contention that all of its payments to Interstate, other than that allocated to the costs of suit and attorneys' fees, should be

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[15]This case involved a conviction on a nolo contendere plea which would ordinarily permit the company convicted to avoid having the plea constitute an admission in the subsequent litigation under sec. 4 of the Clayton Act. See *A. B. Dick Co. v. Marr*, 95 F. Supp. 83, 101 (S.D.N.Y. 1950). Since sec. 162(g) provides for disallowance of two-thirds of the treble damages on a conviction on a nolo contendere plea, it may be that in promulgating sec. 1.162–22(c), Income Tax Regs., respondent considered that at least in these circumstances for years other than the years of the conviction there was no clear violation of a clearly defined public policy absent the United States also obtaining an injunction.

attributed to the period subsequent to May 18, 1977, is without merit. The record in this case is clear, as petitioner recognizes in its alternative argument, that the actual settlement of this case and the mutual releases executed in connection therewith released any and all claims which "were or have been or could in any way have been alleged in the respective pleadings." The pleadings claimed damages for the entire period January 1, 1955, to March 15, 1974. Although petitioner's motions for partial summary judgment were granted and the claims of American Bakeries for the period prior to August 15, 1968, and claims of Interstate for the period prior to January 27, 1972, were dismissed, these decisions had not become final at the time of the settlement of these cases. In fact, both decisions were subject to appeal, and the record here shows that consideration was being given by the plaintiffs to appealing the decisions and also to moving for reconsideration of the granting of the partial summary judgment motions. Petitioner, in its alternative position, recognizes this fact and states that, if the payments made by Fisher Mills to American Bakeries are not to be classified as solely for attorneys' fees and costs, and the payments made by Fisher Mills to Interstate are not to be attributable solely to attorneys' fees and damage claims accruing after January 27, 1972, then the portion of the damage payments should be prorated to the violation in each instance on the basis of the percentage that the 28.5-month period encompassed in the violation for which Fisher Mills was convicted on its nolo contendere plea bears to the total months included in the claims made by American Bakeries and Interstate, based on the initial pleadings, rather than the remaining periods after the granting of Fisher Mills' motions for partial summary judgment.

Based on such an allocation, petitioner arrives at $18,096.58 as the portion of the payment to American Bakeries allocable to the period of the violation and $6,998.40 as the portion of the payment to Interstate allocable to the period of violation, with a resulting disallowance of $12,065.39 of the payment to American Bakeries and $4,665.60 of the payment to Interstate. Respondent, in his reply brief, does not question the method used by petitioner to arrive at the portion of the payment allocable to the violation, but merely argues that petitioner's alternative view fails "because the 'entire periods of the

alleged conspiracy' is comprised of 'related violation' conduct when the conduct occurred outside of the 28.5 month 'violation.' " Respondent concluded from this statement that the amounts "paid with respect to the 'related violations' are also subject to disallowance under section 162(g)."[16]

Since we have concluded that there was no "related violation" in the instant case under section 1.162–22(c) of respondent's regulations, we hold that the amount of damages attributable to the violation of antitrust laws by Fisher Mills paid to American Bakeries is $18,096.58, of which $12,065.39 is properly to be disallowed as a deduction under section 162(g), and that the portion of the payment by Fisher Mills to Interstate attributable to the violation by Fisher Mills of the antitrust laws is $6,998.40, of which $4,665.60 is to be disallowed under section 162(g).

The second issue is whether the two-thirds disallowance under section 162(g) applies to damages Fisher Mills paid to ITT prior to the commencement of a lawsuit by ITT under section 4 of the Clayton Act.

Respondent argues that the two-thirds disallowance applies to the payments Fisher Mills made to ITT even though section 162(g)(2) provides that the disallowance applies to payments made in settlement of "any action brought under section 4" of the Clayton Act. Although the settlement of ITT's claims against Fisher Mills occurred prior to the institution of a suit, respondent contends that we should look beyond the plain words of section 162(g) and hold that the two-thirds disallowance applies because permitting a deduction for petitioner's payments to ITT would violate the spirit of section 162(g). Respondent argues that defining deductibility in terms of whether or not a civil antitrust suit was filed is an unintended technicality that would defeat congressional intent.

Petitioner contends that the payments made to ITT are deductible in full because section 162(g) is only operative when a lawsuit is commenced. Petitioner points out that payments

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[16]In fact, respondent in his reply brief makes the following statement:

It is interesting to note, and consistent with respondent's theory of the case, that petitioner states in support of its alternative theory:

"This allocation would be consistent with the mutual release executed upon the settlement which provided that in consideration of the payment, the parties released any claims which 'were or have been, or could in any way have been alleged in the respective pleadings * * *'"

Fisher Mills made to ITT were made solely on the basis of the ITT agreement and the payments were based on a formula derived from the amount of the payment the defendants made to American Bakeries when the case was settled. Since the ITT settlement did not follow the institution of "any action" by ITT, petitioner contends that none of the payments made fall within the two-thirds disallowance provisions of section 162(g).

We conclude that the payments petitioner made to ITT are not subject to the two-thirds disallowance imposed by section 162(g) because the payments were not made "in settlement of any action brought under * * * section 4" of the Clayton Act.

Section 162(g) was enacted for the purpose of disallowing deduction of two-thirds of the damages paid only in antitrust cases involving "hard-core violations where intent has been clearly proved in a criminal proceeding." S. Rept. 91–552 (1969), 1969–3 C.B. 423, 597. To deny a deduction of two-thirds of the damages paid in a situation where the parties have settled prior to the initiation of a lawsuit would discourage antitrust litigants from reaching a settlement prior to the initiation of costly litigation. The statute limits the disallowance to those instances where an action has been brought under section 4 of the Clayton Act.

We hold that Fisher Mills' payments to ITT are fully deductible since settlement was reached prior to initiation of any action by ITT. The use of the phrase "any action" in section 162(g)(2) makes the deductibility limitation turn on the filing of a complaint for treble damages, and in the absence of such a filing, we hold that petitioner's settlement payments to ITT are deductible in full as an ordinary and necessary business expense. Sec. 162(a); *Commissioner v. Tellier*, 383 U.S. 687 (1966); *Grossman & Sons, Inc. v. Commissioner*, 48 T.C. 15, 31 (1967) (deduction allowed for damages paid in settlement of civil suit by the United States under the False Claims Act which followed a related criminal suit because disallowance would not frustrate public policy); *Central Coat, Apron & Linen Service, Inc. v. United States*, 298 F. Supp. 1201 (S.D.N.Y. 1969) (deduction allowed for payment of legal fees incurred in defense of prosecution for antitrust law violation but deduction denied for payment of fine for antitrust law violation).

The final issue for decision is whether the purchaser's assumption of the lessee's leasehold obligation increases the lessee's amount realized upon the sale of its assets. Respondent argues that Societe was obligated to Fisher Properties, Inc., to repair the roof of the leased business premises by June 30, 1980, according to the amended lease which provided that the leasehold interest was subject to the repair obligation. Respondent contends that Societe was relieved of its repair obligation when Golden Grain purchased Societe's leasehold interest and therefore Societe realized income to the extent it was relieved of its obligation to repair the roof. Respondent states that the $2,004,751 purchase price of Societe's assets was composed of the $500,000 obligation of Societe assumed by Golden Grain plus the $1,504,751 cash payment by Golden Grain to Societe.

Petitioner contends that Societe's obligation owed to Fisher Properties, Inc., to repair the roof on the leased premises was not relieved or discharged as a result of Societe's sale of its assets to Golden Grain because Fisher Properties, Inc., did not relieve Societe of its roof repair obligation.

Pursuant to the sales contract dated July 27, 1979, between Societe and Golden Grain, Golden Grain assumed full responsibility for repairing the roof and assumed Societe's responsibility to complete such repairs under the terms of the plant lease. In consideration thereof, the contracting parties agreed to a $500,000 offset to the amount Golden Grain owed Societe for the purchase of Societe's assets. To the extent Societe was relieved of this obligation, Societe realized income. The purchase agreement specifically provides that in consideration of Golden Grain's assumption of Societe's responsibility to repair the roof pursuant to the terms of the July 26, 1979, lease, Golden Grain is to be credited the amount of $500,000 against the purchase price of Societe's assets. Thus the purchase price of Societe's assets was $2,004,751, not $1,504,751 as claimed by petitioner. Societe received the benefit of being relieved of its obligation to Fisher Properties, Inc., in the amount of $500,000. This relief from liability constituted a part of the amount received by Societe upon the sale of its assets.

We conclude that the discharge by Golden Grain of Societe's obligation to Fisher Properties, Inc., to repair the roof of the leased premises was equivalent to the receipt of $500,000 by Societe. See *Brown v. Commissioner*, 22 T.C. 147, 150 (1954),

affd. 220 F.2d 12 (7th Cir. 1955). Pursuant to the clear language of the sales contract, Golden Grain assumed Societe's obligation pursuant to the July 27, 1979, lease to repair the roof of the building. As we stated in *Brown v. Commissioner*, *supra* at 151: "Income may be realized in a variety of ways, other than by direct payment to the taxpayer, and, in such situations, the income may be attributed to him when it is in fact realized."

In *United States v. Hendler*, 303 U.S. 564 (1938), the Supreme Court held that if any amount of the taxpayer's liabilities are assumed and paid by a transferee, gain is recognized to the full extent of such assumption and payment. The Court stated (p. 566):

> It was contended below and it is urged here that since the Hendler Company did not actually receive the money with which the Borden Company discharged the former's indebtedness, the Hendler Company's gain of $534,297.40 is not taxable. The transaction, however, under which the Borden Company assumed and paid the debt and obligation of the Hendler Company is to be regarded in substance as though the $534,297.40 had been paid directly to the Hendler Company. The Hendler Company was the beneficiary of the discharge of its indebtedness. *Its gain was as real and substantial as if the money had been paid it and then paid over by it to its creditors.* The discharge of liability by the payment of the Hendler Company's indebtedness constituted income to the Hendler Company and is to be treated as such. [Fn. ref. omitted; emphasis added.]

When Golden Grain assumed the responsibility for repairing the roof on July 27, 1979, Societe received a benefit in that Societe was no longer responsible for making such repairs. Therefore, we conclude that Societe realized income in the amount of $500,000 as a result of Golden Grain's assumption of Societe's repair responsibilities. See, e.g., *United States v. Hendler*, 303 U.S. 564, 566 (1938); *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 729 (1929).

Petitioner, in its brief, argues that the only theory upon which income could result to Societe from the assumption by Golden Grain of its obligation to repair the roof on the building it leased from Fisher Properties, Inc., is the relief of Societe of an obligation. Petitioner argues that since Societe's obligation was to another subsidiary of petitioner, there was no relief of an obligation outside the corporate family. Petitioner overlooks the fact that a company outside the corporate family assumed the obligation to spend $500,000 for roof

repair that otherwise would have required an expenditure by a member of the corporate family, Societe. Petitioner cites no authority for its contention that the relief by Golden Grain of Societe's obligation is not income to Societe, because the obligation of Societe was owed to another subsidiary of the parent of Societe, and we have found no authority to support this position of petitioner. Neither are we impressed with any logic to this position espoused by petitioner.

We conclude that respondent properly included the $500,000 obligation of Societe's assumed by Golden Grain in the amount received by Societe on the sale of its operating assets.

Decision will be entered under Rule 155.

LESLIE C. CURTIS AND JOAN CURTIS, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 12978–80. Filed June 24, 1985.

Petitioner, a California resident, held a 9.5-percent interest in a Florida limited partnership. In 1978, respondent inspected petitioner's 1976 return, and subsequently inspected the books of account of the limited partnership without notifying petitioner. *Held*, inspection of the books of account of the limited partnership does not constitute a second inspection of petitioner's books of account, and thus does not violate sec. 7605(b), I.R.C. 1954.

Leslie C. Curtis, pro se.
Edward M. Robbins, Jr., for the respondent.

WILBUR, *Judge*: Respondent determined deficiencies of $5,296 in the petitioners' Federal income taxes for 1976, and of $13,627 for 1977. After concessions, the issues for decision are (1) whether respondent made a second inspection of the petitioners' books of account in violation of section 7605(b),[1] and, if so, (2) whether the appropriate remedy for such

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as in effect during the years in issue, and any references to Rules are to the Tax Court Rules of Practice and Procedure.

violation is to invalidate the deficiency notice issued by respondent.[2]

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioners resided in Encino, California, during the taxable year in issue and at the time they filed the petition in this case. They timely filed joint Federal income tax returns for the taxable year in issue.

In 1978, agents of the Internal Revenue Service's Los Angeles District examined petitioners' 1976 Federal income tax return. A decision was made to accept the return as filed, and a letter to that effect, commonly referred to as a "no-change letter," was sent to petitioners.

In 1976 and 1977, petitioner Leslie C. Curtis, Jr.,[3] was an investor in a limited partnership (Rock Properties, Ltd., operating out of Miami, Florida) that generated certain losses and other tax benefits. On November 21, 1978, the Jacksonville, Florida, District Office of the Internal Revenue Service notified the Los Angeles District Office that it was inspecting the books of account and tax return of the partnership, in which petitioner owned a 9.5-percent limited partnership interest. As a result of this inspection, respondent disallowed a portion of petitioner's claimed distributive share of the partnership losses, and several items of tax credit (including an investment credit) for the years 1976 and 1977. Petitioner was not informed that the partnership books were being examined, and he did not become aware that the inspection had occurred until he received the statutory notice of deficiency. The parties have settled the substantive issues relating to the investment, but disagree over the propriety of an alleged second inspection without notice for 1976 and the consequences of an improper second inspection.[4]

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[2] Petitioners assert that any subsequent deficiency notice would be barred by the statute of limitations.

[3] As the facts herein relate solely to the activities of Leslie C. Curtis, Jr., all references to "petitioner" will refer to the petitioner-husband.

[4] The petition further asserts that "General partners of the two partnerships involved have informed petitioner that no examinations for any partnership years have been concluded, therefore no adjustments are proper as of April 14, 1980." At trial, petitioner appeared to have

OPINION

The Internal Revenue Code provides the following restrictions on the examination of taxpayers:

> No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary or his delegate, after investigation, notifies the taxpayer in writing that an additional inspection is necessary. [Sec. 7605(b).[5]]

We must decide whether the inspection of the partnership books of Rock Properties, Ltd., by the Jacksonville District Office constitutes a second inspection of petitioner's books of account. If we find that respondent has made a second inspection in violation of the requirements of section 7605(b), we must determine whether the proper sanction is to invalidate the deficiency notice.

Respondent appears to have conceded that the examination of petitioner's 1976 Federal income tax return constitutes an "inspection of a taxpayer's books of account." The facts revealed at trial, however, indicate that the "inspection" consisted only of an examination of petitioners' Form 1040. The law is settled that a "review of the Form 1040, and accompanying schedules, does not constitute an inspection of a taxpayer's 'books of account.' " *Benjamin v. Commissioner*, 66 T.C. 1084, 1097 (1976), affd. 592 F.2d 1259 (5th Cir. 1979); *Geurkink v. United States*, 354 F.2d 629 (7th Cir. 1965); *Collins v. Commissioner*, 61 T.C. 693 (1974). Assuming that one inspection had already occurred, however, we nevertheless would find no violation of section 7605(b) because we hold that no second inspection of petitioner's books of account took place.

Petitioner argues that the inspection of the limited partnership's books of account by respondent's agents in Jacksonville constitutes an inspection of his own books of account. We find this interpretation to be inconsistent with the purpose and plain meaning of section 7605(b). In *Benjamin v. Commission-*

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abandoned this argument. In any event, he did not introduce evidence in support of the facts alleged in the petition regarding this issue, and we therefore need not consider it. Rule 142(a).

[5] Sec. 1906(b)(13)(A) of the Tax Reform Act of 1976 (Pub. L. 94-455, 90 Stat. 1834) amended sec. 7605(b) by substituting the word "Secretary" for "Secretary or his delegate." The change was effective as of Feb. 1, 1977.

er, supra at 1098, we stated that "To inspect the 'books of account' would require, at a minimum, that the respondent have access to and physically view a taxpayer's books and records." Petitioners argue that, because a partnership is not itself a "taxpayer" within the meaning of the Internal Revenue Code, an inspection of the partnership books is an inspection of the books of its partners. See sec. 701.

In *Moloney v. United States*, 521 F.2d 491, 501 (6th Cir. 1975), the court stated that the target of section 7605(b) is "the unauthorized invasion of the taxpayers' own books and consequently his personal privacy." The court held on the facts before it that an inspection of the books of a partnership consisting of only two persons constituted an inspection of the books of the individual partners because it was "merely an extension of the persons of the taxpayers themselves." (521 F.2d at 501.) See also *United States v. Lenon*, an unreported case (E.D. Wis. 1977, 42 AFTR 2d 78–5810, 78–1 USTC par. 9159) (involving a subchapter S corporation).

The Sixth Circuit, in *Moloney v. United States*, *supra*, however, faced facts significantly different from those presented in this case. Moreover, the Ninth Circuit Court of Appeals, the court to which this case is appealable, has issued strong admonitions against an expansive reading of section 7605(b). *De Masters v. Arend*, 313 F.2d 79, 87 (9th Cir. 1963). For these reasons, we decline to hold that the inspection of the books of account of this limited partnership is equivalent to the inspection of the books of each of its limited partners. See *Williams v. United States*, an unreported case (W.D. Tex. 1980, 46 AFTR 2d 80–5906, 80–2 USTC par. 9740) (involving a limited partnership).

Section 7605(b) was enacted to protect taxpayers from repetitive investigations used by the Internal Revenue Service as a means of harassment. The section was not intended, however, to function as a severe restriction upon the powers of the Commissioner. *United States v. Powell*, 379 U.S. 48, 55–56 & n. 13 (1964); *Collins v. Commissioner*, *supra*; 61 Cong. Rec. 5855 (Sept. 28, 1921). Accordingly, the Ninth Circuit Court of Appeals has stated that the powers of the Commissioner—

> are to be liberally construed in recognition of the vital public purposes which they serve; the exception stated in Section 7605(b) is not to be read so broadly as to defeat them. A limited construction of Section 7605(b) is also supported

by the law's general antipathy to the erection of barriers to the ascertainment of truth, and the policy against judicial intervention of the investigative stage of tax matters because of the danger of undue delay in the collection of the revenues. [*De Masters v. Arend*, *supra* at 87; fn. refs. omitted.]

Were we to reach the conclusion that an inspection of the books of a limited partnership is per se an inspection of the books of each partner, respondent's ability to evaluate the tax positions of limited partnerships would be hampered seriously. Each time respondent wished to examine the books of a limited partnership, he would first need to obtain a complete list of its partners, and then notify each partner whose individual books may have been examined previously that a "second inspection" was about to occur. This severe restriction upon the powers of the Commissioner was not intended by Congress, and we decline to impose it upon the Commissioner by indulging to an absurd extreme the legal fiction that a partnership is not an entity in itself, but is merely an aggregate of its partners.

It is clear that section 7605(b) does not restrict respondent in his inspections of the books of third parties. E.g., *De Masters v. Arend*, *supra* at 86; *Application of Magnus*, 299 F.2d 335 (2d Cir. 1962); *Hubner v. Tucker*, 245 F.2d 35, 38–39 (9th Cir. 1957). The Second Circuit has stated that "Our courts should not permit interventions which delay government action at the investigation stage unless the interest asserted is direct and immediate." *Foster v. United States*, 265 F.2d 183, 189 (2d Cir. 1959) (Lumbard, C.J., concurring); *Application of Magnus*, *supra* at 337. Thus, courts have uniformly refused to extend the protection of section 7605(b) to a shareholder in situations involving an inspection of the books of the corporation. E.g., *Kolom v. Commissioner*, 644 F.2d 1282 (9th Cir. 1981), affg. 71 T.C. 235 (1978); *Geurkink v. United States*, 354 F.2d at 631. Nor does the rule apply to the books of mere co-owners of property. *Grossman v. Commissioner*, 74 T.C. 1147, 1156 (1980).

In considering section 7605(b), a distinction between an inspection of the books of a corporation and an inspection of the books of the limited partnership involved in the instant case is not warranted merely because the partnership is not a "taxpayer" within the meaning of the Internal Revenue Code. See *Williams v. United States*, *supra*. As the Supreme Court

has stated, "a 'partnership is regarded as an independently recognizable entity apart from the aggregate of its partners' for a number of purposes under the Internal Revenue Code." *Bellis v. United States*, 417 U.S. 85, 97 n. 6 (1974), citing *United States v. Basye*, 410 U.S. 441, 448 (1973). For example, the Court in *Bellis v. United States*, *supra* at 93, held that partnerships may represent "organized institutional activity" to such an extent that a partner's Fifth Amendment rights do not attach to the books of the partnership. We believe that a partnership likewise may have an institutional identity sufficient to distinguish an inspection of its books of account from an inspection of a partner's books for purposes of section 7605(b), at least under the circumstances here present.[6]

Bellis involved a partner who held a 45-percent interest in a law firm partnership composed of three individuals. The Supreme Court acknowledged that, with respect to the assertion of Fifth Amendment rights, the case "explore[d] the outer limits of the analysis." 417 U.S. at 94. The Court ultimately concluded that the three-man partnership had an established institutional identity despite its small size, stating:

> This was not an informal association or a temporary arrangement for the undertaking of a few projects of short-lived duration. Rather, the partnership represented a formal institutional arrangement organized for the continuing conduct of the firm's legal practice. The partnership was in existence for nearly 15 years prior to its voluntary dissolution. Although it may not have had a formal constitution or bylaws to govern its internal affairs, state partnership law imposed on the firm a certain organizational structure in the absence of any contrary agreement by the partners; for example, it guaranteed to each of the partners the equal right to participate in the management and control of the firm, and prescribed that majority rule governed the conduct of the firm's business. The firm maintained a bank account in the partnership name, had stationery using the firm name on its letterhead, and, in general, held itself out to third parties as an entity with an independent institutional identity. It employed six persons in addition to its partners, including two other attorneys who practiced law on behalf of the firm, rather than as individuals on their own behalf. It filed separate partnership returns for federal tax purposes, as required by section 6031 of the Internal Revenue Code, 26 U.S.C. section 6031. State law permitted the firm to be sued, and to hold title to property, in the partnership name, and generally regarded the partnership as a distinct

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[6] Indeed, Congress has made the implicit explicit by enacting sec. 402(a) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, 96 Stat. 648 (Sept. 3, 1982) which provides a comprehensive mechanism for conducting audits at the partnership level.

entity for numerous other purposes. [*Bellis v. United States*, *supra* at 95–97; fn. refs. and citations omitted.]

The Court went on to add, however, that "This might be a different case if it involved a small family partnership." *Bellis v. United States*, *supra* at 101.

In *United States v. Wood*, 435 F. Supp. 870 (W.D. Ky. 1977), the District Court decided that a partnership composed of only two people met the *Bellis* standard despite the facts that the business was conducted without a formal partnership agreement, without a partnership office, without partners who held themselves out as such, without the maintenance of partnership books of account, and without property held in the partnership name.

The instant case is much simpler than *Bellis* and *Wood*. Petitioner made an investment through Rock Properties, Ltd. Rock Properties, Ltd., was a limited partnership in which petitioner held only a 9.5-percent interest. The partnership operated out of Florida; petitioner resided in California. State law restricted petitioner's right to participate in the management of the partnership, and limited his liability for partnership activities. Fla. Stat. Ann. secs. 620.01, 620.07 (West 1977). The partnership was required to file a separate information return. Sec. 6031.[7] In addition, petitioner did not physically possess the partnership books of account, and was not required to deliver any books a second time. We are unable to see how one could regard the partnership and petitioner herein as one and the same for purposes of the second inspection rule. Certainly, this case is distinctly different from the case of the couple who had long conducted a family business as partners in *Moloney v. United States*, *supra*, on which petitioner principally relies.

On facts similar to those in the instant case, one court has held that the taxpayers' "situation was more like that of corporate investors." *Williams v. United States*, *supra*, 46 AFTR 2d at 80–5909, 80–2 USTC par. 9740, at 85,443. Examination of the books of the limited partnership before us should not be regarded as a second inspection of petitioners' books.

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[7] Like the record in *Bellis v. United States*, 417 U.S. 85, 96 n. 4 (1974), the record in the instant case is "quite sketchy." The Supreme Court relied in large part upon the assumption that the partnership operated in accordance with state law, however, and in the absence of evidence of a partnership agreement modifying state law, we do the same today.

Accordingly, we hold that respondent did not violate the proscriptions of section 7605(b).

Because we find that no violation has occurred, we need not decide whether invalidation of the deficiency notice is the proper remedy for such violation. Compare *Reineman v. United States*, 301 F.2d 267 (7th Cir. 1962), with *Estate of Barker v. Commissioner*, 13 B.T.A. 562, 566 (1928).

Due to other concessions,

Decision will be entered under Rule 155.

PROCEEDINGS DISPOSED OF UPON MEMORANDUM OPINIONS

T.C. Memo.	*Name*
1985–194	Aagaard, Carl M.J. and Earla G.
1985–131	Aaronson, Lewis and Roberta, et al.
1985–168	Achille, Margo A.
1985–297	Adams, Joe J. and Anastasia
1985–268	Adams, Paul W. and Louise B.
1985–294	Adams, Thomas R.
1985–54	Allen, Irving and Juanita
1985–118	Alvarado, Juan Alberto
1985–133	Amos, Michael Wayne
1985–101	Anastasato, Pano and Janice
1985–51	Andersen, Benjamin O. and Kay M.
1985–51	Andersen Trust: Dunnett, et al., Trustees
1985–51	Andersen Trust: Robert Dunnett, et al., Trustees
1985–205	Anderson, A. Levere and Ester L.
1985–172	Anderson, David R.
1985–31	Anderson, L. Milton and Elizabeth L.
1985–104	Anderson, Lloyd G. and Patricia J.
1985–146	Armondo, Joseph and Marion
1985–100	Askew, John D. and Nona B.
1985–22	Austin, Cathy Surwillo
1985–291	Bachler, Earnest J. and Alice A.
1985–197	Baker, Michael A. and Sue B.
1985–274	Bailey, Roberta L., Estate
1985–72	Baratta-Lorton, Mary, Estate
1985–153	Bates, Leornard Alvin and Julie Ann
1985–204	Beauvais, Robert A. and Barbara
1985–195	Behrens, Frederick W. and Ethel
1985–99	Behrman, Irving
1985–25	Beisler, Randall L. and Judith K.
1985–256	Bergman, Ralph Roger and Ingeborg
1985–290	Bergmann, George H. and Maritza L.
1985–37	Bezner, Jerry J.
1985–164	Bidwell, Ivan A.
1985–303	Biggs, Baxter Eugene
1985–284	Biglow, Lucius H., Jr., and Nancy W.
1985–210	Bill Hodges Truck Co.
1985–75	Bishop, Shirley E. Hopkins
1985–197	Blackwell, Arlyn and Sharon
1985–293	Blue Knob Resort, Inc.
1985–93	Booker, S. Kenneth and Barbara A.
1985–66	Boomer, McKinley L.
1985–104	Borra, Carole B.
1985–104	Borra, Frederick C.

T.C. Memo.	*Name*
1985–279	Bramblett, Richard H. and Patsy J.
1985–295	Branch, Marina A. and Malcolm H.
1985–296	Branch, Marina A. and Malcolm H.
1985–91	Brent, James A. and Rose M.
1985–47	Bridickas, Ronald J.
1985–64	Brinson, Hugh Edward, Executor
1985–244	Brown, Gary E. and Mary Ellen
1985–269	Brown, Oliver and Ramona M.
1985–168	Bruno, Theresa J., et al.
1985–293	Bryce's Mountain Resort, Inc.
1985–257	Buhr, Wilford A. and Clara E.
1985–26	Buras, John E.
1985–68	Burford, S. Franklin
1985–71	Burt, Myron F.
1985–242	Bustrycki, Mary L.
1985–308	Butler, Marten C. and Margie
1985–76	Cappetta, Robert and Seena
1985–19	Carr, Jack D. and Louise G.
1985–154	Casper, John M.
1985–37	Cassidy, Sara C., Estate
1985–275	Centronics Data Computer Corp. & Subsidiaries
1985–50	Chief Steward of the Ecumenical Temples and the Worldwide Peace Movement and His Successors, a Corporation Sole
1985–186	Christman, Mark
1985–212	Church of Nature in Man
1985–234	Cipparone, Rocco C. and Kathleen M.
1985–260	Citizens Assurance, Inc.
1985–209	Cleveland, Rollo E.
1985–208	Cobb, Elvie, Transferee of the Estate of Carrie May Duncan, et al.
1985–104	Coffey, David E., et al.
1985–104	Coffey, Florina A.
1985–282	Coleman, Kenneth W.
1985–183	Commerce Union Bank, Executor
1985–173	Community Acceptance Corp.
1985–173	Community Acceptance Corp. of Baton Rouge
1985–173	Community Acceptance Corp. of Donaldsonville
1985–48	Core Special Purpose Fund
1985–311	Corkery, Frank W. and Elizabeth M., et al.
1985–8	Crim, Robert Brian
1985–83	Cronin, Michael and Sharon
1985–142	Croy, Hollis L.
1985–78	D'Angelico, Nicholas and Mary
1985–126	Daggett, Ted W.
1985–169	Daily, Lew David
1985–219	Danielson, Harry E. and Mary
1985–251	Day, Robert V. and Pamela H.
1985–11	Deauville Operating Corp.
1985–219	Deegan, John and Dorothy S., et al.
1985–31	DeGraw, Ernest G. and Nadine
1985–73	Delaney, Joseph Martin
1985–246	Dell, Samuel R. and Eleanor
1985–173	Delta Acceptance Corp.
1985–128	DeNiro, Vincent, Estate, Papalia, Helen M., et al., Administratrices, DeNiro, Louis R., et al. Transferees

T.C. Memo.	*Name*
1985-175	Denny L. Johnson Farms, Inc.
1985-49	Dersarkissian, Roger and Kimiko, et al.
1985-31	Dies, Donald H. and Marian A.
1985-33	Donaldson, Jennie R., Estate
1985-197	Driscoll, Francis X. and Patricia B.
1985-39	Duaine, Laurence A. and Janet C.
1985-38	Dugan, James C.
1985-224	Dummler, James H.
1985-208	Duncan, Carrie May, Estate
1985-279	Easterling, Lawrence H., Jr., and Phyllis R.
1985-247	Ebner, Sondra
1985-104	Elias, Victor and Mildred
1985-177	Ellis, Dorothy N.
1985-279	Enrici, David C. and Marianne
1985-194	Falconer, Kenley W. and Lolita E.
1985-219	Farrow, Jesse M. and Joan H.
1985-214	Fawcett, Bradley Dale
1985-286	Fein-Marquart Associates, Inc.
1985-132	Feldman, Joseph H. and Diane
1985-129	Ferguson, Harry F.
1985-197	Ferreri, John and June
1985-168	Fesco, Clara M. (a.k.a. Marlisle Fesco)
1985-311	Fish, James A. and Mikell F.
1985-24	Fitzgerald, John and Virginia
1985-165	Fleming, Jack and Carolyn Dell
1985-279	Formsma, Gerald R. and Constance Y.
1985-279	Forseth, Arnold T., et al.
1985-232	Fourth Financial Corp. & Consolidated Subsidiaries
1985-82	Fox, William L.
1985-6	Francis, Charlotte
1985-140	Franklin, Lindsay D.
1985-61	Frazier, Joseph and Florence
1985-145	Frederick, Edwin L. and Miriam E.
1985-160	Freeman, Marilyn G.
1985-14	Fugger, Godfred Fred (Fred G. Fugger)
1985-147	Gajewski, L.R.
1985-147	Gajewski, Loren R. and Mervin A.
1985-147	Gajewski, Loren R. and Mervin A., et al.
1985-147	Gajewski, Mervin A.
1985-80	Gale East, Inc.
1985-168	Gasperini, Bonnie
1985-30	Genneken, Arthur J.
1985-298	Gilsdorf, Eugene G., Jr.
1985-136,	Giselbach, Paul T.
1985-51	Gladstein, Richard and Caroline
1985-51	Gladstein Trust: R. Dunnett, et al., Trustees
1985-51	Gladstein Trust: Robert Dunnett, et al., Trustees
1985-264	Goines, Fred J.
1985-197	Golf, George P. and Ramona T.
1985-173	Gonzales Acceptance Corp.
1985-151	Goodman, James C.
1985-266	Gordon, Melvin M. and Barbara M.
1985-23	Gorod, Gertrude
1985-45	Gorton, Erwin W. and Ann M.
1985-166	Graddy, Dennis, Jr.
1985-237	Granado, Gregory T.

T.C. Memo.	Name
1985–174	Grant, James A. and M. Jean
1985–200	Green, Harvey J. and Linda
1985–218	Greenlee, Gale W.
1985–62	Gregory, Roy H.
1985–215	Griffith, John Ike and Effie Merle
1985–51	Gurdin, Michael and Marlene
1985–210	Guyer, Arden G. and Carolyn, et al.
1985–252	Hammond, David L. and Lillian C.
1985–113	Hargrove, James M. and Roleen L.
1985–305	Hedrick, David L.
1985–208	Heilbroner, Julian, Transferee of the Assets of the Estate of Carrie May Duncan, Transferor
1985–176	Hendrickson, Robert R.
1985–77	Hensley, Robert L.
1985–286	Hershenhorn, Robert G. and Esther A.
1985–31	Herzog, Edwin M. and Rochelle A.
1985–10	Hezel, William J. and Mary Ann
1985–141	Hicks, Kerry D.
1985–18	Hilliard, Richard
1985–210	Hodges, Harold L. and Judy L.
1985–56	Hodges, Jo Moonyeen
1985–184	Hollander, Samuel and Carol
1985–183	Hoover, Ephriam H., Jr., Estate
1985–75	Hopkins, George, III, Estate
1985–203	Howard, Ronald E. and Betty J.
1985–213	Howe, Clarence K. and Margaret C.
1985–171	Hrissikopoulos, Charles W. and Albina L.
1985–138	Hughes, Richard
1985–271	Hunter, Robert M. and Linda M.
1985–198	Hymel, Roland J., Jr., and Mary Ann
1985–105	Illinois Association of Professional Insurance Agents, Inc.
1985–69	J.D. Real Estate Co.
1985–174	J. Grant Farms, Inc.
1985–51	Jack Froom, M.D., Medical Corp., a California Corporation
1985–210	Jack Hodges Trucking Co.
1985–262	Jameson, William G. and Betty S.
1985–31	Jaros, Martin R., et al.
1985–175	Johnson, Denny L. and Mary Jane
1985–28	Johnson, J.F. Wilmar
1985–85	Johnson, Marvin E.
1985–287	Jolin, Michael G. and Susan P.
1985–312	Keating, James T. and Gertrude
1985–49	Keith, Lawrence
1985–219	Kelley, James P. and Louise
1985–110	Kempker, Herbert and Patricia
1985–315	Kesselman, Morris and Rita
1985–254	Kessler, George and Mildred
1985–302	Kincaid, Joan D.
1985–315	Kingsbury, Robert S. and Lorraine
1985–114	Kirsch, Kenneth S. and Mavis I.
1985–299	Kleiman, William D.
1985–83	Koehl, Seymour and Ruth J.

T.C. Memo.	*Name*
1985–115	Kohrs, Richard E. and Cherie T.
1985–63	Korecky, Clayton M., Jr.
1985–267	Kritikos, Theodore A. and Be Jo
1985–150	Kurihara, Tetzuo, Estate (supplemental)
1985–90	LaFargue, Esther
1985–236	Lampe, James and Helen M.
1985–89	Lane, Jeffrey S. and Diane A.
1985–152	Latterell, Randy Alan
1985–229	Laurent, Celine
1985–111	Leff, Theodore
1985–51	Leonard, Norman and Marjorie, et al.
1985–51	Leonard Trust: R. Dunnett, et al., Trustees
1985–51	Leonard Trust: Robert Dunnett, et al., Trustees
1985–255	Leve, Aaron J.
1985–145	Liberty Asphalt Corp.
1985–314	LiButti, a.k.a. Robert Presti, and Joan, a.k.a. Joan Presti
1985–107	Liddy, George Gordon and Frances Purcell
1985–315	Lightman, Bernard and Barbara, et al.
1985–300	Lincoln, James D. and Clara M.
1985–104	Lombardi, Sam S.
1985–104	Lombardi, Shirley A.
1985–143	Lonskey, John H.
1985–270	Lota, Victor J. and Barbara R.
1985–13	Love Box Co.
1985–185	Lowry, Roy W. and Ruth E.
1985–32	Lucro, Willis
1985–227	Luechtefeld, Leona
1985–225	Lufkin, Robert K. and Linda M.
1985–3	Madson, Elmer A. and Hazil M.
1985–304	Magin, Morris N. and Janice
1985–279	Mahoney Stephen A., III, and Mary Ann
1985–219	Manes, Stanley L. and Jocelyn G.
1985–283	Markovsky, George
1985–179	Marks, Dennis N. and Nancy S.
1985–288	Marquart, Ronald G. and Linda M.
1985–249	Marshall, Esther S., Estate
1985–57	Martin, Clarence W.
1985–43	Martin, Virgil M.
1985–36	Martinez, Gasper T.
1985–250	Marville, Dennis M.
1985–116	Masters, Barbara
1985–94	Maxin, George, Jr.
1985–34	McCabe, Donald Lee, D.O., Inc.
1985–34	McCabe, Donald Lee and Jean H.
1985–202	McCabe, John F. and Edna M.
1985–163	McCarty, Patrick C. and Deborah A.
1985–75	McConnell, C. Allen, Administrator
1985–31	McCullough, William D. and Linda
1985–64	McDougal, Royce C., M.D., Inc., et al.
1985–64	McDougal, Royce C. and Martha T.
1985–74	McKeown, John F.
1985–191	McMahan, Victor D.
1985–191	McMahan, Victor D. and Cora C.
1985–170	Meredith, James S.
1985–197	Merrick, Dean S. and Marilyn
1985–35	Metz, Wolfgang

T.C. Memo.	Name
1985–135	Mighell, Ronald M. and Leslee E.
1985–51	MISAT Development Corp.
1985–285	Misbin, Morris and Dorothy A.
1985–42	Missett, John G.
1985–42	Missett, Nancy
1985–239	Mitchell, William A.
1985–88	Moccasin Manufacturing & Import Co.
1985–208	Montgomery, Willie Cecil, et al., Coexecutors
1985–208	Montgomery, Willie Cecil, Transferee of the Assets of the Estate of Carrie May Duncan, Transferor
1985–20	Moody, Frank M. and Gloria N.
1985–15	Morant, James C. and Gertrude E.
1985–280	Morgan, Carolyn
1985–51	Muehlenbeck, Robert S. and Carolyn T.
1985–311	Murphy, Robert A. and Constance M.
1985–33	Murray, William E., et al., Executors
1985–261	Neary, Joanne
1985–108	Neel, Wilfred P. and Barbara J.
1985–81	Nelson, Clifford A. and Dorothy M.
1985–292	Nelson, Lowell E. and Jacqueline N.
1985–302	Nickell, Jane K.
1985–120	Nicolaisen, Frederick C. and Linda S.
1985–216	Nies, David T., Jr.
1985–104	Novak, Edwin L. and Karen M.
1985–253	Obering, Ernest A., Estate
1985–252	Obering, Helen Bailey
1985–199	Okin, Samuel
1985–197	Oleynik, Roman J. and Lorraine A.
1985–92	O'Neill, John H. and Marilyn S.
1985–4	Owens, David J.
1985–156	Owens, Shelley J., a.k.a. Shelley J. Litwiller
1985–156	Owens, Shelley J. and Bruce W.
1985–98	Owens, Willard La Vern and Darlene J.
1985–267	Owensby, John W. and Dolores G.
1985–267	Owensby & Kritikos, Inc.
1985–180	Palantekin, Cahit and Ayten
1985–101	Panmarc, Inc.
1985–196	Paoli, Robert Delli, a.k.a. Orlando Delli Paoli
1985–124	Pariseau, Raymond C. and Carol
1985–49	Parker, Jason C. and Elizabeth
1985–263	Parker, Robert N.
1985–51	Patsey Trust: R. Dunnett, et al., Trustees
1985–51	Patsey Trust: Robert Dunnett, et al., Trustees
1985–53	Patterson, James A. and Dorothy A.
1985–148	Patton, Luther R.
1985–21	Paul, Lawrence M. and Isabelle
1985–31	Pazdernik, Ludwig and Liselotte
1985–130	Pebley, Billy W.
1985–272	Perkal, Stuart and Pamela
1985–123	Perkins, Ralph Howell
1985–211	Person, Lotus J.
1985–197	Peterson, Roy C.

T.C. Memo.	*Name*
1985-267	Petro-Marine Engineering, Inc., and Subsidiaries
1985-222	Piazza, Joseph B.
1985-267	Piner, Dick H., Jr., and Dorothy S.
1985-117	Plante, James L.
1985-178	Poe, Kenneth and Myrtle L.
1985-197	Polakof, James, et al.
1985-134	Porter, William H.
1985-2	Potter, Dana B.
1985-27	Powell, David J. and Estate of Jeane D.
1985-155	Prairie, Vernon and Dora
1985-182	Price, Pliny A. and Margaret
1985-193	Probber, Edwin and Ellen
1985-67	Pugh, Jack Murray and Elouise Gross
1985-7	Quave, Monsita E.
1985-226	Quint, Philip D. and Francine L.
1985-52	Raab, Kirby H., Estate
1985-309	Rabenold, Juanita B.
1985-310	Rasheed, Al Hakeem Abdul
1985-190	Rasmussen, Emil H. and Patricia M.
1985-219	Reiss, Jerome and Naomi
1985-189	Rexroad, Lyle and Teresa
1985-219	Rhulen, Max H. and Eve J.
1985-219	Rhulen, Walter A. and Judith
1985-248	Rich, John L. and Patricia R.
1985-46	Riester, Walter H. and Janet C.
1985-231	Riley, James E.
1985-245	Rimple, Lucy
1985-51	Robinson, Frank M.
1985-275	Robinson, Prentice I. and Rosalie
1985-220	Rodgers, June M. and Robert D. Barber
1985-307	Roggin, Gary M.
1985-306	Rosanova, Joseph, Jr.
1985-58	Roth Steel Tube Co.
1985-258	Royster, Dan Earl and Dale T.
1985-258	Royster, John E. and Faith S.
1985-258	Royster, W.R. and Minnie M., et al.
1985-65	Rush, Virginia Dell
1985-109	Rutherford, Roy W.
1985-162	St. Louis Science Fiction Ltd.
1985-86	Salladay, Robert M. and Patricia J.
1985-157	Sassak, Alexander C.
1985-219	Schacknow, Paul
1985-219	Schacknow, Steven Roy
1985-235	Scheidt, William B. and Wanda C.
1985-281	Schiffman, Theodor
1985-139	Schneider, Wallace and Arlyne
1985-197	Schwartz, Lee E. and Vera J.
1985-51	Scortia, Thomas N.
1985-265	Shadduck, John E.
1985-161	Shafer, Harvey E.
1985-276	Shand, Charles T.
1985-301	Shenker, Morris A. and Lillian K.
1985-70	Shulman, Daniel A.
1985-257	Siler, Joseph C. and Shirley A.
1985-12	Simonelli, Salvatore
1985-1	Skala, Richard B. and Katharine J.
1985-41	Sloyan, Andrew N. and Marilyn H.
1985-240	Smith, Hoyal
1985-167	Smith, James B. and Jean T.
1985-59	Smith, Wayne Huston

T.C. Memo.	*Name*
1985–5	Snyder, Ronald B. and Suzanne B.
1985–9	Snyder, Stanford I. and Jerry W.
1985–44	Spirtis, Bernard R. and Audrey
1985–119	Stamler, Joseph and Ruth
1985–144	Stapleton, Bernard
1985–197	Steinhebel, Clarence H. and Gertrude
1985–192	Stevens, Frank Bruce
1985–16	Stevens, Raymond J. and Nancy J.
1985–197	Stevenson, David and Frances
1985–293	Stoney Creek Utilities, Inc.
1985–17	Storch, Fenimore and Ida Mae
1985–168	Stutzman, Cathy A.
1985–217	Sullivan, Francis E.
1985–277	Surtronics, Inc.
1985–187	Sweeney, Charles J., Estate
1985–180	Talebi, Ali A. and Sandra
1985–197	Talty, William and Carol
1985–29	Teacherson, George A.
1985–197	Teakle, Ken B. and Marilyn D.
1985–207	Tejon Ranch Co. and Subsidiaries
1985–79	Teuscher, Don A.
1985–181	Theodotou, Chris B. and Helen C.
1985–125	Therberg, William John, II
1985–241	Thomas, Paul F.
1985–51	Thorp, Edward O. and Vivian S.
1985–173	Time Acceptance, Inc., et al.
1985–173	Time Acceptance of Zachary, Inc.
1985–40	Tracy, Donald G.
1985–40	Tracy, Shirley
1985–64	Trow, Thomas Archie, Estate and Elaine
1985–159	Turner, Glenn W. and Alice A.
1985–206	Uhrig, Edward and Evelyn
1985–149	Unroe, Mary Lou
1985–273	Vahlsing Christina Corp., formerly the Christina Corp.
1985–197	Vinci, Leonard A.
1985–95	Vuitch, Milan M. and Florence R.
1985–278	Walker, Jason R. and Marion L.
1985–96	Wallace, Albert C.
1985–102	Walley, Frank Henry and Annabelle Lillian
1985–55	Ward, Robert L.
1985–196	Waterbury Realty Corp.
1985–97	Wellman, James F.
1985–121	Westbrook, Dennis E. and Sylvia J.
1985–238	White, Peter M.
1985–243	Wilcox, Sherman S.
1985–201	Williams, Willard R. and Donna
1985–106	Williamson, Jerry R. and Sharon K.
1985–84	Williamson, Lucas F., Jr.
1985–223	Witherow, William L. and Suzanne L.
1985–287	Witte, Charles F. and Patricia G.
1985–289	Wolfe, Earl W.
1985–112	Wolk, Edmund F.
1985–230	Woltering, Olivia A.
1985–158	Woodhull, Alan L.
1985–233	Woods, Homer Arthur and Barbara Ann
1985–279	Wooldridge, Raymond and Ida
1985–103	Wright, Floyd Augustine
1985–188	Wrolstad, Orville K. and Mildred E.
1985–313	W. W. Enterprises, Inc.

T.C. Memo.	*Name*
1985–122	Young, Claud R.
1985–228	Young, Mary T.
1985–221	Young, Robert G.
1985–127	Young, Robert L. and Joy P.
1985–137	Zadorkin, Nick and Alice
1985–51	Zeiler, Meyer and Floria
1985–259	Zimmerman, Donald, Estate and Edith, Individually
1985–259	Zimmerman, Jonathan
1985–60	Zozaya, Josef

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See **CAPITAL GAINS AND LOSSES, DEPLETION, DEPRECIATION,** and **PARTNERSHIPS.**

ADDITIONS TO TAX

Fraud—Criminal Conviction for Filing False Returns—Applicability of Collateral Estoppel.—Petitioner's conviction under sec. 7206(1) for willfully and knowingly making and subscribing to false income tax return for his taxable year 1978, did not collaterally estop him from denying that any part of his underpayment of tax for 1978 was due to fraud within meaning of sec. 6653(b), since issue of intent, adequately raised by his assertion that underpayment of tax was due to lack of business acumen rather than fraud, was clearly one requiring trial on merits, so that Commissioner's motion for partial summary judgment under Rule 121(b) on issue of petitioner's liability for addition to tax for fraud was denied. *Goodwin v. Commissioner*, 73 T.C. 215, and *Considine v. Commissioner*, 68 T.C. 52, overruled. ***Wright* v. *Commissioner*** 636

Fraud—Failure To Pay Estimated Tax—Collaterally Estopped by Criminal Conviction.—Where petitioner failed to file Federal income tax returns for 1975–78; his Federal income tax liability was underpaid because he filed false Form W-4 certificates with his employer and because he failed to pay estimated tax, and he was convicted of willful failure to file income tax return for 1977, a violation of sec. 7203, Court determined petitioner was liable for (1) taxes on amounts asserted as his income in deficiency notice, since he did not contest these amounts, (2) addition to tax for fraud under sec. 6653(b), since Commissioner affirmatively showed indicia of fraud and petitioner was collaterally estopped by his criminal conviction from denying he willfully failed to file returns for 1977; and (3) addition to tax under sec. 6654 for failure to pay estimated taxes. ***Castillo* v. *Commissioner*** 405

Negligence or Intentional Disregard of Rules or Regulations—Charitable Contribution Issue—Intentional Disregard of Regulation and Statute.—Where petitioner attorney, in claiming deduc-

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ADDITIONS TO TAX—continued
tions for fair market value of his services contributed to organizations eligible to receive deductible charitable contributions, intentionally disregarded reg. 1.170A–1(g), herein determined to be valid; and number of opinions on which he relied indicated that sec. 170(e) would have eliminated any deduction even if reg. was invalid, Court determined petitioner was liable for additions to tax under sec. 6653(a), since he had no reasonable basis for claiming deductions in teeth of both reg. and statute. ***Grant v. Commissioner*** 809

ALIMONY

Payments to W—No Written Separation Agreement or Written Instrument Incident to Divorce.—Where petitioner separated from his wife in April 1972, and they were divorced a mensa et thoro in July 1973, Court determined that petitioner was not entitled to alimony deductions under sec. 215 for payments to his wife made in 1972 and in January of 1973, since payments were not made under legal obligation incurred under written instrument incident to divorce or under written separation agreement. ***Grant v. Commissioner***..... 809

AMORTIZATION

Organizational and Other Legal Expenses—Covenant Not To Compete—Sec. 248 Election and Requisite Proof.—Court determined (1) petitioner was not entitled to amortize its $942 legal organizational expenses, since deduction of entire amount was inconsistent with any election it might validly have made under sec. 248(c), and remaining $3,400 legal expenses were to be added to bases of corporate assets acquired in transaction herein determined not to qualify as sec. 368(a)(1)(D) reorganization, and deducted by way of depreciation in amounts determined by Commissioner; and (2) price of covenant not to compete was amortizable over 6-year term, and not over 31-month period that payments were made, since petitioner failed to persuade Court that New York courts would refuse to enforce covenant, and it failed to produce requisite strong proof that 6-year term was not intended life of covenant. ***Warsaw Photographic Associates, Inc. v. Commissioner*** 21

BASIS

See **CORPORATIONS** and **GAIN OR LOSS.**

CAPITAL EXPENDITURES

Payments for Administrative Leasing Services—Computer Equipment Lease—Capital Expenditure or Expense.—Where petitioners purchased computer equipment packages to lease to others and each entered into 41-month lease with company X whereby he agreed to pay company Y $225 monthly for first 12 months of lease for administrative leasing services to be performed over entire 41-month period of lease, Court determined petitioners could not deduct $225

CAPITAL EXPENDITURES—continued
payments under sec. 162 but were required to capitalize payments and to recover costs by amortizing them over 41-month period of computer equipment lease, since expenditures created separate and distinct intangible asset for each petitioner that would extend over entire term of lease, the right to receive administrative services in the future (*Commissioner v. Lincoln Savings & Loan Assn.*, 403 U.S. 345, followed); and therefore petitioners were not entitled to investment tax credit, since they failed to satisfy 15% requirement of sec. 46(e)(3). ***Seligman v. Commissioner*** 191

CAPITAL GAINS AND LOSSES
See also **DISTRIBUTIONS, ESTATES AND TRUSTS, EXEMPT ORGANIZATIONS,** and **TAXES.**

Transfer of Contract Rights Under Franchise Agreements—Capital or Income—Availability of Installment Method.—Where petitioners transferred their contract rights in janitorial and building maintenance franchise network on July 1, 1976, and reported proceeds of transfer under installment method of accounting, Court determined, on facts and under case law, (1) contract rights that were transferred constituted capital assets under sec. 1221, since they were similar to, if not in fact, those of an equity owner; (2) transfer was sale of capital assets under sec. 1222, since all of petitioners' rights were transferred permanently to purchaser; and (3) sale was properly reported under sec. 453 installment method, since petitioners did transfer property, transfer constituted sale, and sales proceeds were not received as compensation for personal services. ***Foy v. Commissioner*** 50

COMMISSIONER OF INTERNAL REVENUE
See also **INCOME, LIMITATIONS,** and **UNITED STATES TAX COURT.**

Prohibited Second Inspection—Inspection of Limited Partnership's Books—Not Equivalent to Inspection of Books of Each Limited Partner.—Where petitioner, California resident, held 9.5% interest in Florida limited partnership; and in 1978, Commissioner inspected petitioner's 1976 return, and subsequently inspected books of account of limited partnership without notifying petitioner, Court determined inspection of books of account of limited partnership did not constitute second inspection of petitioner's books of account, and hence did not violate sec. 7605(b). ***Curtis v. Commissioner*** 1349

COMPENSATION
See **INCOME.**

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CONSOLIDATED RETURNS

Proper Entity After Merger To Receive Deficiency Notice—Successor Common Parent's Motion To Dismiss for Lack of Jurisdiction—Applicability of Reverse Acquisition Rule.—Where X corporation was common parent of affiliated group that filed consolidated returns for taxable years; in 1969 before November 26, petitioner corporation Y and its wholly owned subsidiary Z were formed; in Nov. 26, 1969, merger, X was dissolved, Y took X's name, X's shareholders became sole shareholders of Y, and X's assets were acquired by Z; on Dec. 2, 1969, Commissioner was notified of X's dissolution and that Z had been designated as successor agent for affiliated group for pre-merger years; in 1972 Commissioner mailed deficiency notice to Y for affiliated group's pre-merger taxable years; and Y moved to dismiss for lack of jurisdiction on ground that Z was successor agent for affiliated group and proper entity to receive statutory deficiency notice, Court determined Y became common parent for group under reverse acquisition rule of reg. 1.1502-75(d)(3), so that deficiency notice was valid, and Y's motion to dismiss was denied.

Southern Pacific Co. v. Commissioner (docket No. 7502-72)..... 375
Southern Pacific Co. v. Commissioner (docket No. 8648-72)..... 395

Subsidiary's Net Operating Loss Carryover From Consolidated Return Year to Separate Return Year—Parent's Waiver of Loss Deduction After Termination of Affiliation—Agency Relationship Not Affected.—Where petitioner corporation X was wholly owned subsidiary and member of affiliated group filing consolidated returns from 1971 until July 24, 1975, when parent corporation Y sold X to certain officers and employees of X; on its 1975 and 1976 separate year returns, X claimed deduction for net operating loss carryovers based on loss shown on 1973 consolidated return; Commissioner disallowed 1973 loss deduction, and on Mar. 26, 1980, Y signed waiver Form 4089 agreeing to adjustment; Commissioner disallowed X's carryover deductions on ground that Y was sole agent of each subsidiary in group for 1973, Court denied X's motion for partial summary judgment, since under sec. 1501, when 1973 return was filed, X agreed to be bound by consolidated return regulations and to let Y serve as its agent; under reg. 1.1502-77(a), Y remained authorized agent for Federal tax purposes relating to 1973, and waiver executed by Y bound both Y and X. *Craigie, Inc. v. Commissioner*..... 466

CONTRIBUTIONS

See also **ADDITIONS TO TAX**.

Charitable—Gemstones Donated to Museum—Valuation.—Where petitioners purchased gemstones and minerals in 1977-79, and approximately 1 year after dates of purchase donated them to Smithsonian Institution, which was qualified charitable donee under

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CONTRIBUTIONS—continued

sec. 170(c), Court determined most reliable evidence of fair market value of donated items was their cost to petitioners. ***Chiu v. Commissioner*** 722

Charitable—Tax Shelter Providing Books to Public Libraries—Deduction Limited to Fair Market Value of Donated Books.—Where petitioners participated in charitable contributions tax shelter program involving scholarly reprint books that were purchased at one-third cost of publisher's catalog retail list prices, held for applicable capital gains holding period, and contributed to small rural public libraries qualified to receive deductible contributions under sec. 170(c); and petitioners, on their respective 1975–77 Federal income tax returns, claimed charitable contributions in amounts of approximately 3 times what their "subscriptions" to book contribution program cost them, Court determined (1) transactions were not shams, since qualified recipients received gifts of books belonging to petitioners, which was result intended by sec. 170, and petitioners were entitled to deductions for their charitable contributions, and (2) fair market value of donated books was not more than 20% of publisher's catalog retail list prices, and fair market value was limit of petitioners' charitable contribution deductions, which was approximately 60% of what petitioners paid for their subscriptions to book contribution program. ***Skripak v. Commissioner*** 285

Charitable—Uncompensated Legal Services—Validity of Reg. 1.170A–1(g).—Where during 1972–1974, petitioner attorney performed uncompensated legal services for organizations eligible to receive deductible charitable contributions, Court determined petitioner was not entitled to deduct value of his contributed services to such organizations under sec. 170, since petitioner's services did not coalesce in property that was subject of a charitable contribution, and his charitable contributions were contributions of services disallowed by reg. 1.170A–1(g), which was valid as reasonable interpretation of statute. ***Grant v. Commissioner*** 809

COOPERATIVES

Agricultural—Patronage Dividends—Equitability of Allocation to Members According to Patronage.—Where petitioner was subchapter T local farmers' cooperative that included in its gross income patronage dividends received from regional cooperatives of which it was member; in computing patronage dividends that it deducted under sec. 1382(b) for fiscal 1981, petitioner allocated net income to member-patrons according to their patronage during that year; and petitioner's allocation was adopted by its board of directors and ratified annually by its members, Court determined petitioner's allocation method was equitable, considering stability of its membership, practicalities of allocation, and apparent approval of method by its members. *Lamesa Cooperative Gin v. Commissioner*, 78 T.C. 894,

COOPERATIVES—continued
followed. ***Kingfisher Cooperative Elevator Association v. Commissioner*** 600

CORPORATIONS
See also **DISTRIBUTIONS, ESTATES AND TRUSTS, GAIN OR LOSS,** and **INCOME.**

Assignment of North Sea Oil Rights to Foreign Subsidiary—Subject to Approval of United Kingdom—Effective Date Under U.K. Law.—Where petitioner corporation on Dec. 30, 1975, assigned to its wholly owned British subsidiary certain interests in five projects located in United Kingdom sector of North Sea oil fields, "subject to any requisite consents and approvals being obtained thereafter," and petitioner and its subsidiary were to "use their best efforts to secure the approval of the Department of Energy and any other necessary approvals and consents in connection with the assignment," Court determined that under U.K. law, assignment was not effective during 1975, since assignment was conditional upon obtaining requisite consents and approvals, and "requisite" included both consent of Department of Energy and approval of Inland Revenue, neither of which was obtained in 1975. ***Gulf Oil Corp. v. Commissioner*** 447

Reorganization or Sale of Assets—Stock Distribution Requirements—Utilization of Transferor's Net Operating Losses and Bases for Depreciation of Assets.—Where 10 shareholders of X, holding in aggregate about 20% of X's common stock and none of X's preferred stock, organized petitioner corporation Y in which they each held 10%; and under plan adopted July 2, 1973, X transferred substantially all of its assets to Y for $21,000, and Y assumed X's obligations under leases and work in progress and issued additional 100 shares directly to 10 shareholders in proportion to their stock in Y, Court determined Y was not entitled either to carry over X's bases for depreciation of assets under sec. 362(b) or to deduct X's net operating losses under sec. 381(a)(2), since transaction was not a D reorganization because formal requirements of sec. 368(a)(1)(D) and sec. 354(b)(1) were not met by issuance of 100 shares. ***Warsaw Photographic Associates, Inc. v. Commissioner*** 21

CREDITS AND EXEMPTIONS
See also **DEDUCTIONS** and **UNITED STATES TAX COURT.**

Investment Tax Credit—New Sec. 38 Property—Heating, Ventilating, and Air-conditioning Units in Supermarkets.—Where in fiscal 1977–79, petitioner retail supermarket chain purchased and installed heating, ventilating, and air-conditioning (HVAC) units in several of its stores; because the HVAC units were necessary to meet temperature and humidity requirements of refrigeration equipment in stores, they were not structural components of stores; and they were not portable air-conditioning and heating units, Court determined HVAC

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CREDITS AND EXEMPTIONS—continued
units constituted tangible personal property and qualified as "sec. 38 property" for investment tax credit purposes, since parenthetical language added in 1978 to sec. 48(a)(1)(A) excluded only portable air-conditioning and heating units from definition of tangible personal property. ***Piggly Wiggly Southern, Inc. v. Commissioner*** 739

Investment Tax Credit—Television Game Show Syndication Production Costs—"Qualified Film" Under Sec. 48(k)(1)(B).—Court determined that petitioner corporation was entitled to investment tax credits under secs. 38 and 48(k) for its taxable years 1973, 1974, and 1977, for costs incurred in producing for syndication "To Tell The Truth" television game show tapes, since tapes constituted qualified films within meaning of sec. 48(k)(1)(B) because they were "created primarily for use as public entertainment" and market for tapes was not "primarily topical" or "otherwise essentially transitory in nature," and Commissioner's restrictive "blanket exclusion" interpretation of game shows under reg. 1.48–8(a)(3)(iii) was rejected. ***Goodson-Todman Enterprises, Ltd. v. Commissioner*** 255

Investment Tax Credit and Accelerated Depreciation—Heavy Construction Equipment—Joint Venture Agreements as Leases, Noncorporate Lessor Rules, and Items of Tax Preference.—Where subch. S corporation X, in which petitioners were sole shareholders, entered into joint venture agreements with corporation Y for topsoil removal at mine sites; X subsequently purchased heavy construction equipment for topsoil removal; under agreements, Y advanced to X its share of net profits to provide X funds for payment of sec. 162 expenses; and petitioners claimed investment tax credit and accelerated depreciation deductions for equipment, Court (1) sustained Commissioner's determination that joint venture agreements constituted leases for sec. 46(e)(3) purposes, (2) determined that petitioners were not entitled to claimed investment tax credit, since noncorporate lessor provisions of sec. 46(e)(3) were not satisfied, and (3) sustained Commissioner's determination that accelerated depreciation deductions constituted items of tax preference. **Freesen v. Commissioner** .. 920

Investment Tax Credit and Depreciation on New Equipment—"Placed in Service" Requirement—Remodeled, New, and Relocated Supermarkets.—Where in fiscal 1977–79, petitioner purchased new equipment such as refrigerated display cases, shopping carts, mixers, saws, and scales for use in its remodeled, new, and relocated supermarkets; equipment installed in remodeled stores was in use in year of purchase although stores were not officially opened until subsequent years; and new and relocated stores did not open for business until years subsequent to years in which equipment was purchased, Court determined petitioner was entitled to depreciation and investment tax credits under secs. 167 and 38, only for equipment installed in its remodeled stores, since only that equipment was "placed in service" during years of purchase within meaning of regs.

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CREDITS AND EXEMPTIONS—continued
1.167(a)–10(b) and 11(e)(1) and 1.46–3(d). ***Piggly Wiggly Southern, Inc. v. Commissioner*** 739

DAMAGES
See **EXPENSES—TRADE OR BUSINESS, PENALTIES,** and **RULES.**

DECLARATORY JUDGMENTS
See **FOREIGN CORPORATIONS** and **UNITED STATES TAX COURT.**

DEDUCTIONS
See also **CONTRIBUTIONS** and **EXPENSES—TRADE OR BUSINESS.**

Development Expenditures, Operating Management Fees, and Professional Fees—Coal Mining Venture—Requisite Profit Motive.—Where petitioner, participant in mining program, claimed deduction for "mining development costs," "operating management fees," and "professional fees," Court determined (1) petitioner was not entitled to deduct under sec. 616(a) his allocable share of "mining development costs," since he failed to carry his burden of proving that mining program was organized and operated, at either partnership or partner level, with primary and predominant objective of realizing an economic profit; (2) operating management fees did not satisfy requirements of sec. 162(a), since mining activity was not trade or business within meaning of sec. 162 because it was not engaged in with primary objective of making a profit; moreover, fees were organizational expenses, which would have to be capitalized in any event; and (3) petitioner was not entitled to deduct his allocable share of professional fees, since he failed to carry his burden of proof on this issue. ***Thomas v. Commissioner*** 1244

Tax Shelter—Operating Losses and Investment Tax Credits on Refrigerated Trailer Purchases—"Activity Not Engaged In For Profit."—Where petitioners purchased specially equipped refrigerated highway freight trailers for cash downpayments and nonrecourse promissory notes, which investments yielded substantial tax benefits, Court, considering inter alia that there was no evidence of economic potential that would support $275,000 purchase price of each truck and that petitioners' financial status would enable them to utilize tax benefits, sustained Commissioner's disallowance of claimed investment credits for 1977 and operating losses to extent provided by sec. 183 for taxable years 1977–79, since they did not engage in these activities for profit within meaning of sec. 183. ***Sutton v. Commissioner*** 210

Tax Shelter—Publication Rights to Gothic Novel Not Acquired "For Profit"—Business Expenses, Depreciation, Invest-

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DEDUCTIONS—continued

ment Credit Under Sec. 38, and Interest Disallowed.—Where petitioner acquired publication rights in Gothic novel for $31,000 cash, assignment of $6,000 of first proceeds of sales of books, and assignment of 60 percent of remaining proceeds to be applied against nonrecourse promissory note in amount of $198,000, Court determined (1) on facts, petitioner did not engage in activity with actual and honest objective of making a profit, with result that he was not entitled to deductions claimed on his 1978–80 Federal income tax returns for trade or business expenses under sec. 162(a), production of income expenses under sec. 212(1), depreciation under 167(a), or investment credit under sec. 38; and (2) petitioner was not entitled to deduction for interest under sec. 163 on nonrecourse note, since it was not genuine indebtedness. ***Elliott* v. *Commissioner*** 227

DEFICIENCY NOTICE

See also **CONSOLIDATED RETURNS** and **UNITED STATES TAX COURT.**

Multiple Tax Years—Second Deficiency Notice With Respect to 1 Year—Divisibility for Tax Court Jurisdictional Purposes.—Where on Dec. 8, 1983, Commissioner sent deficiency notice to petitioner corporation for 1978–81; petitioner had previously received deficiency notice for 1978 and filed petitions from both notices; and later petitioner filed motion to dismiss as to all years on ground that Dec. 8 deficiency notice was a second deficiency notice as to 1978 and could not be basis of Court's jurisdiction over years set forth in such notice, Court granted petitioner's motion to dismiss as to 1978, since Dec. 8 deficiency notice was invalid second notice for 1978; but Court denied motion to dismiss as to 1979, 1980, and 1981, since a statutory deficiency notice setting forth several separate taxable years is divisible and may be valid as to certain years even though invalid as to others. ***Stamm International Corp.* v. *Commissioner*** 248

DEPLETION

Advanced Minimum Royalties—Illusory Obligations Under Coal Mining Sublease—Accrual of Royalty Obligations Improper.—Court granted Commissioner's motion for partial summary judgment, since royalty provision requiring petitioner to execute nonrecourse promissory notes payable solely out of coal production and secured only by mining rights under coal sublease, as well as to pay cash and to execute a recourse promissory note, was not a "minimum royalty provision" within meaning of sec. 1.612–3(b)(3); and as matter of law, all events necessary to establish liability on notes in question did not occur during years in issue, and accruals of royalty obligations would therefore be improper. ***Vastola* v. *Commissioner*** 969

DEPRECIATION
See also **CORPORATIONS, CREDITS AND EXEMPTIONS,** and **DEDUCTIONS.**

Intangible Assets in Bank Acquisitions—Allocation of Purchase Price Exceeding Aggregate Book Values—Valuation of Nondepreciable Intangibles Under Residual Method.—Where in 1973–74 petitioner bank holding company acquired two banks at prices exceeding aggregate book values of assets, Court determined (1) petitioner was not precluded from allocating aggregate purchase prices among acquired assets, even though such allocations were not negotiated or calculated at time of acquisition, (2) petitioner was not entitled to sec. 167 depreciation deductions for loan premium, since it failed to show that it paid more than book value for loans held by acquired banks, or that fair market value of those loans exceeded their book value on date of acquisition, (3) petitioner was not entitled to depreciation deductions for core deposits held by acquired banks, since it failed to provide evidence for taxable years, other than hindsight evidence based on subsequent events, of useful life or reasonableness of depreciation claimed for acquired deposit accounts, and (4) value of goodwill and other nondepreciable intangibles was to be determined under residual method of valuation. ***Banc One Corp. v. Commissioner*** 476

DISTRIBUTIONS
See also **ESTATES AND TRUSTS.**

Corporate Liquidation—Election as to Recognition of Gain by Noncorporate Shareholder—"Acquired" Defined.—Where petitioners received 24,950 shares of General Motors common stock when their personal holding company, Dunmovin, was liquidated during June 1978 pursuant to sec. 333; Dunmovin, which was passive shareholder of duPont, had received the GM stock from duPont in 1962, 1964, and 1965 as result of divestiture order by Supreme Court in antitrust case; Dunmovin had acquired the duPont stock before 1954 and duPont had acquired these GM shares before 1954, Court determined petitioners realized long-term capital gain for 1978 by virtue of distribution of these shares, since applying guidelines articulated in case history and considering legislative history and policy underlying statutory provisions, "acquired" was to be accorded its "common and ordinary meaning" for purposes of sec. 333(e)(2), and Dunmovin "acquired" its GM stock after Dec. 31, 1953. ***Knowlton v. Commissioner*** 160

DIVIDENDS
See **INCOME.**

EMPLOYEES' TRUSTS

Excise Tax on Prohibited Transactions—Profit-sharing Plan's Loans to Employer Outstanding on Effective Date of Sec. 4975—Employer's Liability.—Where in 1971–75 petitioner corporation obtained loans from tax-exempt employee profit-sharing plan that it administered and paid no interest on borrowed funds, and loans remained outstanding on Jan. 1, 1975, effective date of sec. 4975, Court determined (1) petitioner was liable for excise tax imposed by sec. 4975 with respect to loans, since considering statutory language and congressional intent, sec. 4975 applied to loans made before effective date, and (2) sec. 4975 did not constitute ex post facto law with respect to loans, since applying sec. 4975 to loans did not constitute retroactive application of ERISA, considering that event giving rise to petitioner's liability was not obtaining but maintaining loans after effective date. ***Hockaden & Associates, Inc. v. Commissioner*** 13

ESTATE TAX
See **ESTATES AND TRUSTS.**

ESTATES AND TRUSTS
See also **INCOME TRANSFEREES.**

Grantor Trust—Attribution of Partnership Losses—Ordinary or Capital Gain on Disposition of Partnership Interest.—Where petitioner was grantor of four irrevocable trusts established in 1975 that were grantor trusts within meaning of sec. 674(a) because trustee had power to add beneficiaries; trusts purchased limited partnership interests in X, which in turn purchased limited partnership interest in Y; Y obtained nonrecourse loan from bank to finance production of motion picture; petitioner recognized Y's losses on his joint income tax returns for 1975–77; and on Jan. 1, 1978, trustee renounced his power to add beneficiaries, and trusts ceased to be grantor trusts, Court determined, for petitioner's taxable year 1978, (1) reg. 1.1001–2(c), example (*5*), is valid interpretation of secs. 671, 674, and 1001 because grantor is treated as owner of trust property, and perfection of trusts resulted in taxable disposition of trust property by petitioner to trusts, (2) Commissioner had authority to apply reg. 1.1001–2(c), example (*5*), retroactively, and (3) petitioner's gain on disposition of partnership interests was taxable as ordinary income pursuant to secs. 741 and 751. ***Madorin v. Commissioner*** 667

Gross Estate—Gifts in Contemplation of Death—Statutory Presumption Overcome.—Where decedent made gifts to his children and their spouses in 1973–77 before his death on Mar. 6, 1977, Court determined transfers were not includable in decedent's estate as gifts in contemplation of death under sec. 2035(a), since on facts, petitioner estate met burden of proving decedent had no more than general expectation of death, such as all persons entertain, when he

ESTATES AND TRUSTS—continued
made gifts, and gifts continued pattern of gift-giving to family in appreciation of past services over decades of working family farms together and for pleasure of giving. ***Estate of Lidbury v. Commissioner*** 146

Gross Estate—Special Use Valuation of Farm—Surviving Tenants in Common Not Required To Sign Recapture Agreement.—Where decedent, who died in 1978, was tenant in common with no right of survivorship in two farms with individuals who were not his heirs or devisees; decedent bequeathed undivided ⅓ interest in all his real estate to his daughter and remainder in trust to grandchildren; and petitioner estate elected special use valuation of farm property under sec. 2032A, Court determined surviving tenants in common were not required to execute recapture agreement referred to in sec. 2032A(d)(2), since there was no statutory authority for such requirement, and reg. 20.2032A-8(c)(2) was therefore invalid by including as persons having interests in designated property all "co-tenants" insofar as that term includes surviving tenants in common. ***Estate of Pullin v. Commissioner*** 789

Gross Estate—Value of Residence Transferred to Revocable Trust With Retained Life Estate Not Reduced To Reflect Spouse's Right to Life Estate Under Antenuptial Agreement—Spouse's Right to Life Estate Deductible as Claim Against Estate.—Where in 1972 decedent transferred his personal residence to revocable trust in which he reserved life estate, with remainder to his son and grandchildren; in 1974, decedent, then 75 and employed, entered into antenuptial agreement with W, then 73, in which he promised to provide W with life estate in residence and W waived certain rights acquired upon their marriage, decedent never amended trust or executed will as promised in antenuptial agreement; and 4 months after decedent's death in 1977, his estate paid W $10,000 under agreement in which she relinquished her life estate, Court determined (1) full value of residence was includable in estate under secs. 2036(a) and 2038(a) without reduction for value of W's life estate, since W's right to life estate under antenuptial agreement was not statutorily created right that attached to decedent's real property by operation of law, and (2) $10,000 payment to W was deductible under sec. 2053(a) as claim against estate, since W's claim to life estate under antenuptial agreement was supported by adequate and full consideration. ***Estate of Carli v. Commissioner*** 649

Income in Respect of Decedent—Corporate Liquidations—Right To Receive Distributions.—Where before his death, decedent was shareholder in 2 corporations, county had taken all corporate assets by eminent domain, and corporations, which had voted to dissolve and liquidate under sec. 337, had distributed part of condemnation proceeds to shareholders and were litigating claims to additional amounts of compensation for their assets; and after decedent's

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ESTATES AND TRUSTS—continued

death, his estate received additional liquidation proceeds in fiscal 1974 from corporations and in fiscal 1976 from trustees in liquidation, Court determined amounts received by petitioner estate in 1974 and 1976 constituted income in respect of decedent under sec. 691(a)(1), and petitioner was not entitled to stepped-up bases for stock rights under sec. 1014(a) and (c), since at time of decedent's death, liquidations had progressed to point where decedent had right to receive liquidation proceeds. ***Estate of Bickmeyer v. Commissioner*** 170

Marital Deduction—Bequest to Spouse Conditioned Upon His Surviving Distribution of Estate—Terminable Interest.—Where decedent W, who died in 1977, provided in her will for gift of her personal property and realty to H, and made alternate gift of such property in event that H failed "to survive distribution of my estate"; H survived W and entry of Judgment of Final Distribution 13 months later; and petitioner estate claimed marital deduction of gift on its estate tax return, Court determined disposition was terminable interest within meaning of sec. 2056(b) for which no marital deduction was available, since under California laws disposition to H could have terminated or failed 6 months after W's death and since petitioner failed to prove W intended phrase "fails to survive distribution of my estate" to mean anything other than its well-established technical meaning in California probate practice. ***Estate of Harmon v. Commissioner,*** 329

Marital Deduction—Texas Widow's Allowance—Terminable Interest.—Court determined widow's allowance awarded by Texas Probate Court was terminable interest not qualifying for deduction from decedent's gross estate under sec. 2056, since widow's entitlement to 1 year's allowance under Texas law is contingent upon widow's not having separate property adequate for her maintenance for 1 year following H's death, and such an interest is not indefeasible and unconditional as of moment of H's death. ***Estate of Snider v. Commissioner*** 75

Special Use Valuation of Farm Real Property—Cash Lease by Qualified Heirs—Imposition of Recapture Tax on Cessation of Qualified Use.—Where decedent died Jan. 29, 1978, leaving 209-acre crop-producing family farm to his seven children as tenants in common; farm was leased to decedent's son-in-law on sharecrop basis until August 1979, when personal representative executed 1 year cash lease of entire tillable portion of farm (79%) with unrelated third party, which lease was approved by local probate court; and estate had properly elected special use valuation for farm under sec. 2032A on Form 706 filed on Sept. 29, 1978, Court determined petitioner heirs were liable for recapture tax under sec. 2032A(c)(1)(B), since cash lease constituted cessation of qualified use within meaning of sec. 2032A(c)(7). ***Martin v. Commissioner*** 620

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ESTATES AND TRUSTS—continued

Tax Court Jurisdiction—Commissioner's Denial of Sec. 6166 Election To Pay Estate Tax in Installments and Disallowance of Sec. 2053 Administration Expense for Interest—Part of Deficiency Resulting From Denial of Election.—Where petitioner estate elected under sec. 6166 to pay estate tax in installments and claimed deduction under sec. 2053 for administrative expense for interest on Federal estate tax, payment of which petitioner elected to defer under sec. 6166, Court (1) granted Commissioner's motion to dismiss for lack of jurisdiction portion of case relating to deferred payment of Federal estate tax, since Commissioner's denial of sec. 6166 election did not create or affect amount of deficiency, but (2) determined it had jurisdiction as to whether petitioner qualified for interest deduction, since Commissioner's disallowance created deficiency. ***Estate of Meyer v. Commissioner*** 560

ESTOPPEL

See also **ADDITIONS TO TAX.**

Collateral—Bankruptcy Court's Prior Adjudication of Tax Liability—Mutuality of Parties.—Where Federal Bankruptcy Court had concluded, in final judicial proceeding, that petitioner and her deceased husband had no Federal income tax liability for 1975–77, and Commissioner issued notice of deficiency to petitioner, who was not a party in earlier bankruptcy proceeding, for same taxable years, Court determined Commissioner was collaterally estopped from asserting issues previously decided by Bankruptcy Court, since (1) petitioner constituted "party" in prior proceeding in all but technical sense, and sufficient mutuality of parties existed to activate principle of estoppel (*Montana v. United States*, 440 U.S. 147), and (2) *United States v. Mendoza*, 464 U.S. 154 was not applicable, so that, there being no genuine issue of material fact, petitioner's motion for summary judgment under Rule 121(a) was granted. ***McQuade v. Commissioner*** 137

EXCISE TAX

See **EMPLOYEES' TRUSTS.**

EXEMPT ORGANIZATIONS

See also **UNITED STATES TAX COURT.**

Gain on Sale of Property Used Directly in Performance of Exempt Function—Social Club—Applicability of Nonrecognition Provisions of Sec. 512(a)(3)(D).—Where in 1974 petitioner, tax-exempt sec. 501(c)(7) social club that operated golf course, realized gain of $148,640 on $850,000 sale of 55-acre tract that it had acquired in 1972 for possible expansion and without investment intent, and applied proceeds as follows: $318,500 to refund of member assessments for original acquisition, $265,000 for payment of note, and $5,541

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EXEMPT ORGANIZATIONS—continued

selling expenses, leaving balance of $260,959, which it applied towards $304,511 purchase of property used directly in performance of its exempt function, Court sustained Commissioner's contention that "organization's sales price" under sec. 512(a)(3)(D) was $844,459 ($850,000 sales price, less $5,541 selling expenses) and not $260,959 as petitioner contended, and determined nonrecognition provisions of sec. 512(a)(3)(D) were inapplicable, since petitioner's sales price of 55-acre tract, less cost of purchasing other property used for its exempt purpose, exceeded its gain. ***Tamarisk Country Club v. Commissioner*** 756

EXPENSES—NONBUSINESS

Gambling as Trade or Business—Goods and Services Test or Facts and Circumstances Test—Losses as Item of Tax Preference for Minimum Tax Purposes.—On remand of T.C. Memo. 1983-133 from Court of Appeals for Second Circuit (723 F.2d 1062) for further proceedings in accordance with its opinion in which it stated that "goods and services" requirement rather than "facts and circumstances" approach was minimum standard for determing whether taxpayer was engaged in "trade or business," Court determined (1) petitioner was not engaged in a trade or business so as to qualify for deduction of his gambling losses in computing adjusted gross income for purposes of minimum tax, since he did not satisfy such minimum standard, and (2) failure of Congress to permit deduction of his gambling losses for purposes of minimum tax was not unconstitutional. ***Gajewski v. Commissioner*** 980

Insurance Premiums—Portion of Risk Reinsured by Captive Insurance Subsidiary—Risk of Loss Not Shifted.—Where petitioner's wholly owned subsidiary incorporated wholly owned captive insurance subsidiary X; petitioner negotiated coverage for its workers' compensation insurance liabilities with unrelated insurance carrier Y; in addition, Y negotiated with petitioner to have X reinsure portions of petitioner's risk which was insured by Y; and by agreement 92% of premiums paid by petitioner to Y were ceded to X, Court determined 92% of premiums paid to Y were not deductible as ordinary and necessary business expense for insurance, since petitioner failed to shift 92% of its risk of loss. *Carnation Co. v. Commissioner*, 71 T.C. 400, followed. ***Clougherty Packing Co. v. Commissioner*** 948

Residence Maintenance Expenses—Property Not Held for Production of Income.—Where in April 1972, petitioner H separated from his wife and vacated his house; W rented part of house to tenant from September 1972 to late 1974; W vacated house in January 1973; in July 1973, H and W were divorced a mensa et thoro; in 1975, they were divorced a vinculo matrimonii; and petitioner reported no rental income from the house, Court determined petitioner was not entitled to deduct maintenance expenses he paid for house in 1974, since property was not held for production of income under sec. 212(2),

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EXPENSES—NONBUSINESS—continued
absent any basis to attribute to petitioner any of W's activities in renting house, and absent any evidence that petitioner converted property to sec. 212(2) purpose, and considering that petitioner abandoned personal use of house before he paid expenses and that during time he paid expenses, he held house only for sale as soon as divorce was concluded. ***Grant v. Commissioner*** 809

Value of Uncompensated Legal Services in Divorce Proceeding—Pro Bono Work of Attorney—Deductibility.—Where petitioner attorney represented client in divorce proceeding which lasted from 1971 through 1974 and was not compensated for most of services he rendered in that proceeding, Court determined value of petitioner's uncompensated services in divorce proceeding, which he categorized as pro bono publico work, was not deductible under sec. 162, since expenditure of petitioner's labor did not constitute payment of a deductible business expense. ***Grant v. Commissioner*** 809

EXPENSES—TRADE OR BUSINESS
See also **CAPITAL EXPENDITURES** and **DEDUCTIONS.**

Advanced Royalties—Requisite Profit Motive in Coal Mining Venture—Deductions for Accrued Interest and "Costs of Goods"—Development Costs.—Where in 1976 and 1977, petitioners were limited partners in partnership organized to exploit certain coal rights, Court determined that on evidence, petitioners were not entitled to deduct their distributive shares of partnership's claimed loss based on (1) advance royalties partnership "paid" with cash and nonrecourse note and deducted under sec. 162(a), since petitioners failed to prove partnership was organized and operated with primary and predominant objective of realizing economic profit, (2) accrued interest, since nonrecourse note lacked economic substance and hence did not constitute true indebtedness for purposes of sec. 163(a), and (3) "costs of goods—development costs," since petitioners failed to carry their burden of proving that Commissioner's determination was erroneous. ***Seaman v. Commissioner*** 564

Cost of Subordinated Loan Certificates—Physician-owned Medical Malpractice Insurance Company—Deductibility by Physicians or Professional Corporations and Taxability to Employees.—Where physician-owned medical malpractice insurance company was formed in New Jersey in 1976 because of high cost and unavailability of medical malpractice insurance, and to provide initial funding, individual physicians or their professional corporations purchased subordinated loan certificates, which were non-interest-bearing, nontransferable, and redeemable only when named physicians ceased to practice in New Jersey and were no longer insured by company, Court determined cost of certificate was capital expenditure not deductible as ordinary business expense under sec. 162(a), and payment for certificate by professional corporation did not constitute

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EXPENSES—TRADE OR BUSINESS—continued

dividend to shareholder/employee under sec. 301 or income to non-shareholder/employee under sec. 61, since at no time did any individual employee have any right to cash redemption in face amount of certificate that was issued in his name. ***Herman v. Commissioner*** 120

Home Office—Separate Structure as "Appurtenant To"—Application of Gross Income Limitation to Deductions Attributable to Use of Separate Structure.—Where petitioner, who was full-time college professor, had gross income of $23,517 and total expenses of $31,986 in 1980 from separate rental and chemical analysis businesses; petitioner used separate office building situated only 12 feet behind his residence on same lot as house; all expenses for separate structure, including taxes, utilities, interest, and insurance, were included in common bills; and petitioner claimed total deductions of $1,965 for expenses allocable to use of office building, Court determined (1) on facts, separate structure used as office was "appurtenant to" petitioner's house within meaning of sec. 280A(f)(1)(A), and therefore constituted part of the dwelling unit, and (2) petitioner is entitled to deduct under sec. 280A(c)(1)(C) expenses allocable to business use of his office building, since sec. 280A(c)(5) limits deduction allocable to use of separate structure to gross income derived from such use, but does not require that gross income be first reduced by other deductions attributable to businesses carried on in such structure. ***Scott v. Commissioner*** 683

Home Office Leased to Employer—Bona Fides—Statutory Exception for Rental Use.—Where in 1979 petitioner, who was shareholder, employee, and director of public accounting firm, leased for $5,400 office and garage space in his newly constructed home to his company; petitioner used office on regular basis exclusively for company business; company clients met with petitioner in his home office; and petitioner reported rental income and deducted his costs of maintaining leased space, which he calculated as 15% of his home, Court determined (1) on evidence, rental arrangement was bona fide; (2) payments, to extent they were reasonable, constituted rent, and under sec. 280A(c)(3), expenses attributable to rental were deductible under sec. 280A(c)(5); and (3) considering expert testimony, reasonable rental was $3,120, and 9% of house was devoted to rental use. ***Feldman v. Commissioner*** 1

Treble Damages Under Antitrust Laws—Settlement Payments—Sec. 162(g) Applicability.—Where in 1974, petitioner's subsidiary was found guilty on nolo contendere plea of violating sec. 1 of Sherman Antitrust Act; no injunction was sought or obtained for violation; subsequent civil actions under sec. 4 of Clayton Act for treble damages brought against subsidiary by corporations X and Y were settled before trial; similar claim of corporation Z against subsidiary was settled before commencement of suit; and petitioner

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EXPENSES—TRADE OR BUSINESS—continued
claimed that entire payment of settlement of X's suit was allocable to plaintiff's attorneys' fees and litigation costs, Court determined (1) on facts, only a portion of amount paid to X was attributable to plaintiff's attorneys' fees and litigation costs, and balance was damages; (2) sec. 162(g) applied to disallow ⅞ of damages paid for years of violation of which subsidiary was convicted, but did not limit deduction of damages paid for other years because "related violation" as defined in reg. 1.162–22(c) did not exist due to absence of injunction with respect to violation involved in criminal proceeding; and (3) sec. 162(g) did not limit deduction of damages paid to Z, since payment was made prior to commencement of lawsuit and thus was not made "in settlement of any action brought" under sec. 4 of Clayton Act. ***Fisher Co.'s* v. *Commissioner*** 1319

FOREIGN CORPORATIONS
See also **CORPORATIONS.**

Transfer of Property From United States—Commissioner's Adverse Ruling as to Tax Avoidance Purpose—Declaratory Judgment.—Where U.S. corporation X, which needed capital to continue profitable operations in its oil and gas exploration business, formed Canadian corporation Y to avoid marketability problems due to SEC restrictions that would accompany public offering of X's stock; and petitioners, U.S. shareholders of X, brought sec. 7477 declaratory judgment action after Commissioner determined that exchange of all outstanding shares for X for majority interest in Y failed to qualify for nonrecognition treatment under sec. 351 or 368(a)(1)(B) because it was "in pursuance of plan having as one of its principal purposes the avoidance of Federal income taxes" within meaning of sec. 367, Court determined, in light of all facts and circumstances, Commissioner's adverse determination was unreasonable, since administrative record failed to disclose substantial evidence of a principal purpose of tax avoidance either by way of potential avoidance or tax deferral as contended by Commissioner. ***Pitcher* v. *Commissioner*** 85

GAIN OR LOSS

Sec. 351 Exchange—Partner's Assumption of Partnership's Liability—Basis and Share of Liabilities Determined.—Where petitioner partner and partnership executed "Assumption of Liability," whereby petitioner purported to assume obligation on nonrecourse note executed by partnership and secured by deed of trust on partnership property; and thereafter, partners exchanged their partnership interests for shares in corporation in sec. 351 exchange, with corporation assuming partnership obligation to which note was subordinated, Court computed petitioner's sec. 357(c) gain (1) by determining adjusted basis of petitioner's partnership interest immediately before sec. 351 exchange by referring to relevant portions of

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GAIN OR LOSS—continued
secs. 722, 752, and 705(a), and (2) by determining amount of sec. 357 liabilities which, contrary to petitioner's contention, included $299,900 debt assumed by petitioner, and by determining petitioner's share of such liabilities. ***Smith v. Commissioner*** 889

GIFTS
See also **ESTATES AND TRUSTS.**

Remainder Interest In Jointly Held Property Not Transferred Upon Spouse's Death—H's Rights Not Limited by Joint and Mutual Will—State Law.—Where H and W executed joint and mutual will in 1951 devising their entire estate to survivor and providing that their children were to receive entire estate upon death of survivor; upon W's death in 1964, her estate consisted primarily of her one-half interest in farm jointly owned with H; and will was not admitted to probate until H's death in 1977, Court determined H's estate included value of unsold assets acquired at W's death, since, under Illinois law, title to realty owned by H and W as joint tenants automatically passed to H by operation of law when W died, joint and mutual will was not a contract that acted to limit H's right of disposition of property at time of W's death, inasmuch as it was not admitted to probate when W died, and H could have revoked it before his death. ***Estate of Lidbury v. Commissioner*** 146

INCOME
See also **CAPITAL GAINS AND LOSSES, ESTATES AND TRUSTS, EXPENSES—NONBUSINESS, EXPENSES—TRADE OR BUSINESS, INSURANCE COMPANIES, LIMITATIONS, SMALL BUSINESS CORPORATIONS,** and **TAXES.**

Averaging—Student's Eligibility—Social Security Survivor Benefits as Self-Support.—Court determined that petitioner, who was full-time student and not a full-time member of labor force throughout 4 base-period years, was not an "eligible individual" for purposes of income averaging under sec. 1303(c)(1), since in light of legislative history, case law, and other relevant material, amounts received from Social Security Administration as survivor benefits, which were not subject to taxation, constituted "support" payments provided by the Federal Government and not by the taxpayer-recipient. ***Baldwin v. Commissioner*** 859

Commissioner's Allocation—Pharmaceutical Corporation and Its Puerto Rican Subsidiary—Arm's-Length Prices of Sales to Parent.—Where in 1965, petitioner pharmaceutical corporation X organized wholly owned Puerto Rican subsidiary Y which qualified for sec. 931 benefits; in December 1966, X transferred Darvon-N patents and know-how to Y in sec. 351 nonrecognition transaction; after 1966 and throughout taxable years, Y manufactured Darvon and Darvon-N for sale to X, which marketed products throughout United States;

INCOME—continued
during 1971–72, Y was sole manufacturer of Darvon and Darvon-N; and at end of 1972, Darvon patent expired, and several companies began to compete by manufacturing and marketing certain products, Court determined (1) Y's ownership of manufacturing intangibles was recognized in determining arm's-length prices between X and Y, and prices Y charged X caused distortion of income justifying reallocations; (2) although reallocations of income were warranted, Commissioner's adjustments to prices under sec. 482, which denied Y any income from manufacturing intangibles, were unreasonable; and (3) arm's-length prices were computed for 1971–72 under reg. 1.482–2(e)(1)(iii), and for 1973, under reg. 1.482–2(e)(2). ***Eli Lilly & Co. v. Commissioner*** 996

Sale of Assets—Purchaser's Assumption of Responsibility for Repairing Roof—Seller's Realization of Income.—Where petitioner's subsidiary X leased commercial real estate from petitioner's subsidiary Y; X had obligation to repair roof on leased premises; before termination of lease, X sold its assets to unrelated company Z which assumed X's obligation to repair roof; and agreed purchase price was reduced by agreed cost of roof repairs, Court determined value of Z's assumption of leasehold obligation to repair roof was part of amount realized by X upon sale of its assets. ***Fisher Co.'s v. Commissioner*** 1319

Stock Warrants Taxable to Underwriter as Compensation—Assignment to Shareholders Equivalent to Dividend—Shareholder's Transfer to Foreign Situs Trust for Annuity Subject to Grantor Trust Rules.—Where in 1965–67, corporation X underwrote issuance of securities for which it received commissions and nonqualified options on warrants to purchase stock or securities it was underwriting; warrants were not traded on established securities market and were subject to various restrictions; X later assigned most of warrants to its shareholders; and in 1968 shareholder A transferred his interest in some of warrants to foreign situs trust, but he retained significant control over trust property, Court determined (1) X received warrants as compensation for underwriting services, and validity of regs. 61–15(b) and 1.421–6 was upheld as providing rules for valuation of warrants received by underwriters for services; (2) transfer to shareholders of warrants constituted dividend, taxable at the time a fair market value for warrants could be determined; and (3) transfer of warrants by A to foreign situs trust constituted transfer with retained interest in ownership and beneficial enjoyment of warrants, so that trust income was taxable to A under grantor trust rules. ***Weigl v. Commissioner*** 1192

Wages of Nun—Earned in Individual Capacity or as Agent of Religious Order—Assignment of Income.—Where in 1980, petitioner nurse, who was member of religious order of Roman Catholic Church, worked with approval of order as health care professional

INCOME—continued
with Federal Government agency that assigned employees to work in regions lacking adequate medical services, and pursuant to her vow of poverty, endorsed all her paychecks over to order, which paid her living expenses and gave her minimal monthly allowance for personal expenses, Court determined petitioner was liable for taxes on her wages, since on facts, she earned income in her individual capacity, and not as agent of order. ***Schuster v. Commissioner*** 764

INSURANCE COMPANIES
See also **EXPENSES—TRADE OR BUSINESS.**

Life Insurance Company—Deductibility of State Franchise Tax—Requirement of Direct Relationship to Production of Investment Income.—Where Sixth Circuit (720 F.2d 420) determined that to be deductible from gross investment income under sec. 804(c)(1), general expenses must be directly related to production of investment income, and remanded 77 T.C. 845 to Tax Court to determine whether Ohio franchise taxes paid in 1972–74 were so related, Court determined no portion of Ohio franchise tax was deductible, since such tax was not directly related to the production of investment income. ***Union Central Life Insurance Co. v. Commissioner*** 361

Life Insurance Company—Renewable Accident and Health Insurance Policies—Qualification as "Guaranteed Renewable."—Where petitioner life insurance company issued accident and health insurance policies and properly computed, using 2-year preliminary term method, mid-terminal reserve of zero dollars for policies in force for 2 years or less, Court determined such policies in force for 2 years or less qualified as "guaranteed renewable" under reg. 1.801–3(d). *National States Insurance Co. v. Commissioner*, 81 T.C. 325, and *United Fire Insurance Co. v. Commissioner*, 81 T.C. 368, followed. ***National Savings Life Insurance Co. v. Commissioner*** 509

Life Insurance Company—Reserves Acquired in Statutory Merger—Includable in Opening Balance in Revalued or Unrevalued Amount.—Where petitioner X acquired life insurance reserves from Y in statutory merger; both X and Y were life insurance companies under subch. L; and X had elected under sec. 818(c) to revalue its preliminary term reserves, but Y had not so elected, Court determined that sec. 381 did not require X to add acquired reserves to its sec. 810 opening balance in revalued amount, but rather in unrevalued dollar amount. ***National Savings Life Insurance Co. v. Commissioner*** 509

Life Insurance Company—Reserves for Policies Containing Both Term and Permanent Insurance Components—Revaluation.—Where petitioner life insurance company held reserves on life insurance policies containing both term insurance and permanent insurance components, Court determined (1) for purposes of sec.

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INSURANCE COMPANIES—continued
818(c)(2) reserve revaluation, petitioner was required to segregate its contracts into their facially discernible components of term and permanent insurance in force during years in issue and to apply sec. 818(c)(2)(A) only to permanent components and sec. 818(c)(2)(B) only to facially discernible term components covering a period of more than 15 years at time of issuance, and (2) sec. 818(c)(2) requires a proportional segregation of reserves based on reserve that would have been required for separate components had they been issued as separate policies. ***National Savings Life Insurance Co. v. Commissioner*** 509

INTEREST
See also **DEDUCTIONS** and **ESTATES AND TRUSTS.**

Partner's Payment of Interest on Partnership's Note—Assumption of Liability—Not Interest "On Indebtedness."—Where petitioner partner and partnership executed "Assumption of Liability," whereby petitioner purported to assume obligation on nonrecourse note executed by partnership and secured by deed of trust on partnership property; and thereafter, partners exchanged their partnership interests for shares in corporation in sec. 351 exchange, with corporation assuming partnership obligation to which note was subordinated, Court determined that payments made by petitioner after incorporation transaction, purporting to be interest on note, were not deductible as interest under sec. 163(a), since payments were not made on indebtedness. ***Smith v. Commissioner*** 889

JURISDICTION
See **CONSOLIDATED RETURNS, DEFICIENCY NOTICE, ESTATES AND TRUSTS,** and **UNITED STATES TAX COURT.**

LIMITATIONS
See also **TRANSFEREES.**

6-Year Period—Omitted Income—Commissioner's Discovery of Omission Before Expiration of 3-Year Period.—Where deficiency notice was issued more than 3, but less than 6, years after petitioners' 1976 return was filed, and in motion for partial summary judgment, petitioners contended that 6-year statute under sec. 6501(e)(1)(A) did not apply, conceding for purposes of motion that items of gross income were omitted from return, Court denied motion, since (1) fact that Commissioner's agents discovered items of omitted income during audit before expiration of 3-year period did not preclude Commissioner's resorting to 6-year statute, (2) fact that petitioners had reported some income from source of one item of omitted income did not preclude such item from being considered as such, and (3) capital gains from sales of commodities, and not gross proceeds from such sales, reported by petitioners, were to be treated as

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LIMITATIONS—continued
"amount of gross income stated in the return" for purposes of sec. 6501(e). ***Insulglass Corp. v. Commissioner*** 203

LOSSES
See also DEDUCTIONS, ESTATES AND TRUSTS, EXPENSES—TRADE OR BUSINESS, and PARTNERSHIPS.

Commodity Tax Straddles—"Transaction Entered Into for Profit"—Deductibility Under Sec. 108 of Tax Reform Act of 1984.—Petitioners' losses in trading in gold futures straddles during 1979 were allowed under sec. 108 of Tax Reform Act of 1984, since in light of legislative history, sec. 108 adopts objective test and directs that losses be allowed on disposition of position if that particular straddle transaction held "a reasonable prospect of any profit" at time straddle was acquired, and temporary regs. were plainly inconsistent with sec. 108 as so construed, and to extent they adopted *Smith-Fox* test were invalid. ***Miller v. Commissioner*** 827

NET OPERATING LOSS
See CONSOLIDATED RETURNS and CORPORATIONS.

PARTNERSHIPS
See also COMMISSIONER OF INTERNAL REVENUE, ESTATES AND TRUSTS, GAIN OR LOSS, and INTEREST.

Ownership of Leased Computers—Economic Substance—Amortization of Syndication Costs.—Where limited partnership, formed to acquire used IBM computer equipment for lease or sale, retained investment firm to act as its agent in soliciting offers to subscribe to its Class A limited partnership units and leased computers to third parties, Court determined (1) partnership was true owner of computer equipment for tax purposes, since on facts and considering inter alia economic substance test, transactions were genuine leases (*Frank Lyon Co. v. United States*, 435 U.S. 561, followed), and (2) petitioners could not amortize over life of partnership equity placement fee paid investment firm for syndication of shares, since considering rule in corporate context and subsequent legislation, syndication fees were nondeductible capital costs recoverable only upon liquidation of partnership. ***Estate of Thomas v. Commissioner.*** 412

Partner's Varying Interest in Taxable Year—Use of More Favorable Accounting Method—Burden of Proof.—Where limited partnership was formed on Apr. 11, 1976; petitioner did not acquire his partnership interest until July 19, 1976; and Court held (83 T.C. 103), under sec. 706(c)(2)(B), that petitioner must adjust his distributive share of limited partnership's deductible items to reflect his varying interest, Court determined (1) Commissioner's burden of proof extended only to applying reasonable method of accounting for petitioner's varying interest in partnership, not to proving and

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PARTNERSHIPS—continued
applying most favorable method for petitioner; (2) Commissioner's proration method of computing partnership loss or gain at end of taxable year and allocating yearend total ratably over year was reasonable method; and (3) petitioner had right to use a more favorable accounting method, but he failed to carry his burden of proving facts necessary for interim closing of partnership books as an alternative method, so that his motion to vacate decision was denied. ***Johnsen v. Commissioner*** 344

Special Loss Allocation to Limited Partner—Economic Substance—Variation of Ownership Interest During Taxable Year.—Where Louisiana partnership in commendam was formed in 1977; new partners in commendam were admitted in July, November, and December 1978; petitioner became partner in commendam in November, acquiring 2% interest in partnership; under agreement, to account for partners' varying interests, partnership's overall tax loss was allocated pro rata to periods beginning and ending on admission of new partners, based on number of days in each period; under agreement, petitioner received special allocation of approximately 23% of third period loss; petitioner's capital account was reduced for losses allocated to her; but upon partnership liquidation or sale, proceeds would not be distributed in accordance with capital account balances, and petitioner would not be required to restore any deficit in her capital account, Court determined (1) on facts, special allocation to petitioner lacked economic effect under sec. 704(b), and (2) for purposes of redetermining petitioner's distributive share of partnership's loss, her "interest in the partnership" within meaning of sec. 704(b) was required to reflect variation of her ownership interest during year under sec. 706(c)(2)(B). ***Ogden v. Commissioner*** 871

PENALTIES
See also **UNITED STATES TAX COURT.**

Damages for Instituting Proceedings Primarily for Delay—Advanced Minimum Royalties in Abusive Tax Shelter—Frivolous Cause.—Where petitioners entered into coal mining lease with agreement to pay minimum annual royalty payment either by cash or by nonrecourse notes in which payment was to be obtained from all coal mined in excess of 60,000 tons; and petitioners deducted royalty payments which were paid one quarter in cash and three quarters in nonrecourse notes, Court determined (1) minimum royalty provision in reg. 1.612-3(b)(3) was valid (*Wendland v. Commissioner*, 79 T.C. 355, and *Wing v. Commissioner*, 81 T.C. 17, followed); (2) advanced royalties "paid" in 1977-78 were not deductible, since no coal was actually produced in 1977-78, and royalties were not paid under minimum royalty provision as required by reg. 1.612-3(b)(3); and (3) damages were awarded to United States under sec. 6673 for maintaining groundless and frivolous claim, since *same* material facts had been

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PENALTIES—continued
previously adjudicated, petitioners repetitiously raised same issues already decided, and on facts petitioners were involved in abusive tax shelter. ***Oneal v. Commissioner*** 1235

RETURNS
See **ADDITIONS TO TAX.**

RULES
See also **UNITED STATES TAX COURT.**

Rules 30 and 41(a)—Amendment to Pleading and Motion To Dismiss—Damages for Instituting Proceedings Primarily for Delay.—Where Commissioner moved to dismiss for failure to state a claim and petitioner then moved for leave to file amended petition, Court (1) granted petitioner's motion to amend under Rule 41(a), since "a party may amend his pleading once * * * at any time before a responsive pleading is filed," and motion to dismiss is not a responsive pleading under Rule 30; (2) granted Commissioner's motion to dismiss, since amended pleading related back, under Rule 41(d), to time of filing of original pleading, and amended pleading also failed to state claim upon which relief could be accorded; and (3) awarded damages to United States under sec. 6673, since petitioner's pleadings were frivolous and groundless and were filed only for purposes of delay. ***Derksen v. Commissioner*** 355

SMALL BUSINESS CORPORATIONS

Termination of Election—Passive Investment Income—"Gross Receipts" From Commodity Futures Transactions Defined.—Court determined that "gross receipts," within meaning of sec. 1372(e)(5), realized by small business corporation trading in commodity futures contracts, equaled total amount received, unreduced by any fees and commissions, and was not limited to gains from such transactions, as Commissioner contended, so that petitioner corporation had gross receipts less than 20% of which constituted passive investment income, and petitioner's election not to be taxed as tax-option corporation under section 1372(a) was not involuntarily terminated. ***New Mexico Timber Co. v. Commissioner*** 1290

TAXES
See also **CREDITS AND EXEMPTIONS, EXPENSES—TRADE OR BUSINESS,** and **INSURANCE COMPANIES.**

Alternative Minimum Tax—Applicability—Tax Computed Under Maximum Rate on Personal Service Income.—Where in 1981 petitioner computed tax liability based upon 50% maximum rate on personal service income under sec. 1348, and Commissioner applied alternative minimum tax provisions of sec. 55, Court determined that calculation of tax under sec. 1348 does not preclude application of

TAXES—continued
alternative minimum tax under sec. 55 where taxable income falls within the parameters of sec. 55, since sec. 55 is clear on its face and carries out legislative intent to impose alternative minimum tax to the extent that minimum tax exceeds taxpayer's regular income tax liability. **Murphy v. Commissioner** 1284

Alternative Minimum Tax—Capital Gains From Sale of Farmland Development Rights—Not Exempted by Farmland Protection Policy Act.—Where petitioner sold easement of development rights on his farm to Maryland Agricultural Land Preservation Foundation and reported long-term capital gain from transfer on his 1981 Federal income tax return, Court rejected petitioner's contention that Farmland Protection Policy Act, 7 U.S.C. secs. 4201–4209, precluded application of alternative minimum tax under sec. 55, since petitioner's arguments were unpersuasive, and unambiguous provisions of sec. 55 were controlling. **Warfield v. Commissioner** 179

TRANSFEREES

Liability as—Deficiencies of Former Parent—Primary Liability Contractually Assumed in Merger by Subsidiary.—Where X corporation was common parent of affiliated group that filed consolidated returns for taxable years; in 1969 before Nov. 26, corporation Y and petitioner, its wholly owned subsidiary Z, were formed; in Nov. 26, 1969, merger, X was dissolved, Y took X's name, X's shareholders became sole shareholders of Y, and X's assets were acquired by Z; in 1972 Commissioner mailed deficiency notice to Y for affiliated group's pre-merger taxable years, and mailed transferee liability notice to Z for same years; and Z moved to dismiss for lack of jurisdiction on ground that it had primary liability under State law for all pre-merger deficiencies for affiliated group and that transferee liability notice was therefore invalid, and in alternative, to substitute itself as petitioner in its capacity as surviving corporation in merger and as successor in interest to X, and as agent for members of affiliated group, Court (1) determined Z was liable as transferee at law for liabilities of X, since Z contractually assumed X's obligations under merger agreement, notwithstanding Z's primary liability under State law, and (2) denied Z's motions, since Commissioner's notice of transferee liability was proper.

Southern Pacific Transportation Co. v. Commissioner (docket No. 7501–72) 367

Southern Pacific Transportation Co. v. Commissioner (docket No. 8647–72) 387

UNITED STATES TAX COURT
See also DEFICIENCY NOTICE and ESTATES AND TRUSTS.

Commissioner's Motion for Summary Judgment—Energy Tax Credit for Water Source Heat Pump—Retroactivity of Reg.—

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UNITED STATES TAX COURT—continued

Where Commissioner disallowed energy tax credit claimed in 1980 for water source heat pump which was purchased Aug. 21, 1980, and which utilized well water with temperature below 50-degree Celsius minimum requirement in reg. 1.44C-2(h) promulgated Nov. 29, 1980, which applied to 1977 and subsequent years, Court granted Commissioner's motion for summary judgment, since (1) reg. 1.44 C-2(h) was valid; (2) retroactive application was not arbitrary as general matter or as applied to petitioners, considering inter alia that proposed reg., published in May 1979, defined geothermal deposit as having temperature exceeding 60 degrees Celsius; and (3) statements in IRS Publications 17 and 903, properly interpreted, were not contrary to provisions of reg. 1.44C-2(h). ***Peach v. Commissioner*** 1312

Commissioner's Motion To Dismiss for Lack of Jurisdiction—Pre-Filing Notification Letter—Not Equivalent to Deficiency Notice.—Where pre-filing notification letter was sent by District Director to each taxpayer who had invested in certain tax shelter; letter stated that taxpayer's return would be reviewed and any deductions taken in regard to shelter would be disallowed, with consideration given to determination of appropriate "penalties"; and taxpayers filed consolidated petition on ground that pre-filing notification letter constituted deficiency notice, Court granted Commissioner's motion to dismiss for lack of jurisdiction, since letter was not deficiency notice within meaning of secs. 6212(a) and 6213(a), considering, inter alia, letter was not intended to be deficiency notice, did not state that deficiency had been determined, and did not specify year and amount of deficiency. ***Abrams v. Commissioner*** 1308

Commissioner's Motion To Dismiss for Lack of Jurisdiction as to Petitioner in His Individual Capacity—Termination Assessment Against Possessor of Cash—Third Party's Motion To Intervene as Party Petitioner.—Where petitioner denied ownership of certain cash which was found in his possession by police authorities; Commissioner made termination assessment under sec. 6851 against petitioner in his capacity as possessor of cash under sec. 6867; petitioner filed petition both in his individual capacity and in his capacity as possessor of cash; and third party sought to intervene as party petitioner claiming true ownership of the cash, Court (1) granted Commissioner's motion to dismiss for lack of jurisdiction as to petitioner in his individual capacity, since deficiency notice was issued to petitioner in his capacity as possessor of cash and not to him in his individual capacity, and (2) denied third party's motion to intervene as party petitioner, since under case law, third party, to whom statutory notice has not been issued, may not become a party petitioner, and sec. 6867(c) was not applicable because assessment against the possessor of cash had not yet been abated and replaced by assessment against owner of cash. ***Matut, as Possessor of Certain Cash v. Commissioner*** 803

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UNITED STATES TAX COURT—continued

Commissioner's Motion To Dismiss Under Rule 123(b) Issues as to Which Petitioners Had Burden of Proof—Petitioners' Failure To File Court-Ordered Brief—Commissioner's Burden of Proof as to Increases in Deficiencies and Fraud Additions.—Where petitioners filed no Federal income tax returns for 1979–81 before issuance of statutory notices of deficiency; record in case consisted, inter alia, of 598-page transcript, scores of exhibits, altered 1978 Forms 1040 announcing frivolous constitutional objections, delinquent 1978 return filed on Dec. 30, 1981, unsigned Forms 1040 for 1978–81, and final set of Forms 1040 for 1978–81 filed 1 day before trial; and petitioners did not file brief containing "detailed findings of fact" based upon "specific, detailed, easily found and legible evidence," as orally directed by Court to petitioners' counsel and as required under Rule 151, Court granted Commissioner's motion under Rule 123(b) to dismiss all issues as to which petitioners had burden of proof, and Court determined (1) that Commissioner carried his burden of proving amounts of additional income received by petitioners during taxable years at issue, and (2) that petitioners were liable for addition to tax for fraud under sec. 6653(b) for each of years in issue. ***Stringer v. Commissioner*** 693

Commissioner's Post-Trial Motion To Amend Answer Second Time To Assert Applicability of Sec. 6621(d)—Higher Interest Rate on Substantial Underpayments Attributable to Tax Motivated Transactions—Prejudicial to Taxpayer as New Issue.—Where petitioner was partner in limited partnership organized to acquire and distribute motion picture film; in deficiency notice and amendment to answer, Commissioner disallowed petitioner's distributive share of partnership's net loss on grounds inter alia that partnership did not acquire depreciable interest in film, that its depreciable basis in film was overvalued, that loss, if allowable, was limited to amount to which petitioner was "at risk," and that partnership's activities were not engaged in for profit; and after trial and submission of Commissioner's opening brief and petitioner's brief in answer, Commissioner moved for leave to amend his answer second time to assert applicability of sec. 6621(d) which imposes higher rate of interest on substantial underpayments attributable to certain tax-motivated transactions, Court denied motion, since there were significant legal questions which might be raised as to application of section 6621(d), and to allow amendment would unfairly prejudice petitioner. ***Law v. Commissioner*** 985

Court's Dismissal for Lack of Jurisdiction—Petition Filed During Automatic Stay Provided by Bankruptcy Code—Time for Filing Petition Computed.—Where petitioner's original discharge in bankruptcy, dated Nov. 23, 1982, was revoked by Bankruptcy Court on Dec. 5, 1983; Commissioner issued deficiency notice on Apr. 9, 1984; petitioner filed improper petition on July 9, 1984; and

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final discharge in bankruptcy was not issued until Feb. 12, 1985; Court (1) dismissed petition for lack of jurisdiction under 11 U.S.C. sec. 362(a)(8), since petition was filed in violation of automatic stay provisions of Bankruptcy Code, and (2) determined that petitioner had 150 days from Feb. 12, 1985, date of final discharge in bankruptcy, to file new petition with Tax Court under sec. 6213(f). **Thompson v. Commissioner** 645

Jurisdiction Over Sec. 6682 Penalty—Filing False W-4 Certificate—Not Attributable to Deficiency.—Where petitioner filed Forms W-4 containing false information, with result that only minimum Federal income taxes were withheld by his employer during taxable years 1975–78, Court determined it had no jurisdiction over penalty provided in sec. 6682(a), since it was not attributable to a deficiency. *Estate of Young v. Commissioner*, 81 T.C. 879, followed. **Castillo v. Commissioner** 405

Petitioner Limited Partner's Motion for Summary Judgment—Bankruptcy Court's Alleged Determination of Federal Income Tax Liability of Debtor's Limited Partners—Allegation Not Supported by Record.—Where petitioners, who were limited partners in partnership that filed petition in bankruptcy, moved for summary judgment on ground that bankruptcy court had determined their Federal income tax liabilities, Court denied motion since bankruptcy court dealt with employment tax liabilities of debtor, nothing in record suggested there would have been any justifiable reason for bankruptcy court to determine Federal tax liabilities of limited partners, and there was no indication in record that bankruptcy court had asserted jurisdiction over Federal income liabilities of limited partners. **Hulter v. Commissioner** 185

Petitioner's Failure To File Briefs To Comply With Court Order—Dismissal vs. Adverse Determination of Issues—Burden of Proof.—Where for 1980–81, petitioner shareholders presented neither persuasive evidence nor legal ground at trial to establish their entitlement to increased basis in subchapter S corporation to reflect bank loan made directly to corporation and to depreciation on liquor license of disputed value; petitioners did not file seriatim briefs as ordered by Court at conclusion of trial under Rule 151; and petitioners did not appear at hearing to show cause why their case should not be dismissed under Rule 123(b) for failure to prosecute or comply with Rules of Court, Court determined disputed issues against petitioners because of their failure to satisfy their burden of proof. *Stringer v. Commissioner*, 84 T.C. 693, distinguished. **Calcutt v. Commissioner** .. 716

Petitioners' Motion To Consolidate Declaratory Judgment Action and Deficiency Case—Judicial Economy—Resolution of Exempt Organization Issue Dispositive of Declaratory Judgment Action.—Where petitioners, with Commissioner's concurrence, moved under Rule 141(a) to consolidate declaratory judgment action

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brought under sec. 7428 to review Commissioner's revocation of petitioner's exempt status (possibly requiring trial based on other than administrative record), with related case involving transferee liability and income and excise tax deficiencies against organization itself and three directors individually, Court denied motion and stayed declaratory judgment action to avoid needless duplication of effort by parties, since decision in deficiency case would resolve issue of petitioner's exempt status and would necessarily be binding and dispositive of declaratory judgment action. ***Centre for International Understanding v. Commissioner*** 279

Sanctions Under Rule 104—Facts Sufficient To Show Fraud Deemed Established—Failure To Comply With Order Concerning Swiss Bank Account.—Where from 1954 through 1959, petitioner and his brother had partnership that sold drug called Krebiozen, and petitioner thereafter continued business as sole proprietorship, Court rejected both Commissioner's and petitioner's requests, based on new evidence, to reconsider basic conclusions in 54 T.C. 1364 and determined that original findings of fact as modified herein were to be applied to determine costs of goods sold, using same foreign exchange free rate; petitioner was not liable for failure to file timely declarations of estimated tax for 1954 under sec. 294(d)(1)(A), I.R.C. 1939; petitioner was liable for additions to tax for 1955–58 for underpayment of estimated tax under sec. 6654; petitioner was not liable for fraud under sec. 6653(b) for taxable years 1954–59; and Court imposed sanctions under Rule 104 by deeming established facts that were sufficient to sustain Commissioner's deficiencies for 1960–64, as well as additions to tax for fraud, since petitioner willfully failed to comply with Court order directing him to provide his written consent to Swiss bank to disclose bank records of his accounts. ***Durovic v. Commissioner*** 101

VALUATION
See **CONTRIBUTIONS, DEPRECIATION,** and **ESTATES AND TRUSTS.**

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